Small Business Loans Act Studies:

Summaries and Synthesis

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Introduction

The Small Business Loans Act (SBLA) was introduced in 1961. Thirty-seven years later, it remains the primary federal public sector mechanism for facilitating small business access to debt financing. As the significance of small business to the Canadian economy has grown, so too has interest in the effectiveness of the SBLA.

The SBLA's success as a public policy tool is perhaps due to the modifications that have been made to it over time, enhancing what works and fixing what doesn't.

The most substantive changes occurred:

- In 1970, when non-bank financial institutions became eligible SBLA lenders;
- In 1978, when the interest rate switched from a fixed to a variable rate;
- In 1985, when a registration fee of one percent was imposed, and the guarantee rate was changed so that lenders began to carry 15 percent of loan losses;
- In 1993, when the SBLA allowed for 100 percent asset financing, the maximum loan amount was increased to $250,000, the registration fee doubled, and the government's guarantee was increased to 90 percent.
- In 1995, when cost-recovery concerns prompted the increase of lenders' responsibility for loan losses to 15 percent, maximum financing levels returned to 90 percent of asset value, and an annual administration fee was added to the cost of borrowing.[1]

A number of studies have been performed for Industry Canada in the interests of continuing to hone the effectiveness and efficiency of the SBLA. They can be grouped in roughly the following categories:

i) *Capital Leasing Studies*: The question of whether to extend the SBLA to capital leasing has been such a prominent one that it has been explored in depth in a number of studies.

ii) *Economic Impact Studies*: These have attempted, at various points, to measure or predict the economic impact of the SBLA and its loans – primarily in terms of understanding what those loans have meant to the SMEs who took them, and what kinds of employment benefits have resulted.

iii) *Default and Non-Compliance Studies*: One study concerns itself with predicting default rates, and another with the incidence of loan-splitting and other systematic non-compliance.

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[1] Nicole Baer, *Lending Small Business a Helping Hand: The History of the Small Business Loans Act*. Ottawa: Industry Canada.

iv) *Stakeholder Consultations*: These studies have examined the attitudes and opinions of stakeholders and potential stakeholders on a variety of issues. Lenders, borrowers, potential borrowers, and associations have been canvassed for their views.

v) *Cost-Benefit Analyses and Future Evaluations*: These attempt to ascertain where the SBLA could be more efficient (inducing the most benefit to SMEs at the least cost to taxpayers) and how to make it more-so. A few studies have made specific suggestions as to how information could be collected on the SBLA in future in order to allow for future evaluations of it.

These studies are summarized briefly in the following pages. Each study has been encapsulated in one-two pages, with an emphasis on a) points that the author found the most compelling, and b) points that have been brought out in other studies. A compilation of the most salient points emerging from the group of studies is presented on page 38 of this document.

Capital Leasing Studies

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

1995

This study was prepared by Basil Kalymon of Kalymon Consulting Ltd. and submitted to Industry Canada in October, 1995. Its purpose was to assess available data and conduct interviews with members of the Canadian Finance and Leasing Association in order to determine the viability of extending the SBLA to this market.

Capital leases are agreements whereby the owner of a piece of equipment (the lessor) gives the user (the lessee) the right to use the equipment throughout the major part of the equipment's life, in return for a specified series of payments. At the end of the lease term, ownership of the equipment will generally transfer to the lessee. These payments may irregularly spaced but they are set at a rate that does not change for the duration of the lease. Lessors generally have expertise in the equipment they lease, as well as a keen understanding of its value in the market.

The study's key conclusions were that, given the fact that SMEs are major users of leasing as a means of financing business improvements, and that the purpose of the SBLA is to increase financing to SMEs, the extension of the SBLA to capital leasing is consistent with its purpose, and could be done fairly simply.

Kalymon also concluded that the impact of this extension on the SBLA would be small, and that capital lease contracts do not, in principle, constitute a higher risk exposure than loan agreements.

Given that capital leasing is unregulated, Kalymon recognized that strict guidelines would have to be imposed in order to ensure that only reliable and reputable lessors have access to the program.

Kalymon recommended that the SBLA be extended to capital leasing, and that further study be performed to determine precisely how revisions should be made, including a fee structure that would allow for full cost recovery in this portion of the program.

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

1996

Further to Kalymon's work, this study was prepared for Industry Canada by Michael Andrews and Mahmood Iqbal of the Conference Board of 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 to this end.

The Conference Board study distinguishes *capital* leases, which finance equipment for most of its useful life and transfer ownership at the end of the lease period to the lessee, from *operating* leases, which finance equipment for less than its useful life, and at the end of which the equipment is generally returned to the lessor. These differences entail different risks for the lessor. Conceptually, capital leases are equivalent to term loans or conditional sales contracts, both of which are already eligible for SBLA guarantees. Operating leases are more complicated and do not translate as easily into SBLA-type guarantees. (Capital leases, like term loans, involve credit risk only. Operating leases involve a second class of risk for the lessor, which is the cost and difficulty involved in re-leasing equipment or otherwise disposing of it at the end of the lease term.)

The study suggests, therefore, 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 under an expanded SBLA.

Other key issues include the following:

- Given that a low volume of government-guaranteed transactions is expected by industry executives, they were concerned about the costs of establishing registration and reporting requirements.

  The industry is so structured that there are a handful of large participants (AT&T Capital Canada, Commcorp Financial Services, GE Capital Canada, and Newcourt Credit Group) and over 100 specialized niche companies. It is these smaller companies that would suffer disproportionately from the costs of establishing registration and reporting procedures, particularly if the volume of guaranteed business were low.

- Leases are commonly transferred from one company to another. Furthermore, lessors frequently fund their portfolios through asset-backed securities. The compatibility of government guarantees with these practices would have to be examined.

- The fee paid by the lessor would have to be competitive with the guarantee fee paid for a comparable term loan.

- ‘Moral hazard’ assurances would have to be adapted to attempt to ensure that leasing companies continued to use due credit judgement in leasing decisions.

- Some standardization of industry terminology would be necessary in developing lease contracts.

- The loss on a capital lease at any point in time would have to be defined, an issue which is more complex with operating leases than with capital ones, or in cases of equipment without a ready re-sale market.

The Conference Board authors concluded that, while a program that ignored the concerns of the industry would not be used, none of the operational issues raised by the study was insurmountable.

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 (SBLC)

1998

In this study, presented to Industry Canada in March, 1998, the Conference Board prepared and reported on a focus group session to achieve consensus on elements of an extension of the SBLA to capital leasing. The focus group found tremendous support for such a program, which the report provisionally calls the Small Business Capital Leasing Program (SBCL). (It does not attempt to deal with operating leases.)

According to an earlier Conference Board study, lease financing to SMEs by specialized financing companies almost doubled between 1994 and 1996.[2] The industry is dominated by a few large, and over 100 small, specialized finance companies, which makes it extremely competitive with respect to quality of service, ease of access and quick decisions on lease applications. In contrast to banking relationships, businesses tend to shop around before making leasing decisions. In spite of the burgeoning market in capital leases, industry executives suggested that most lease applications that are not approved are rejected because of their lack of a financial track record.

Leasing is attractive to SMEs because of the fixed-rate financing (not fluctuating with the prime rate, as with many loans); the flexibility of repayment schedules (particularly useful for seasonal businesses, for instance); the lessors' expertise with the equipment in question; equipment servicing options; and speed, as credit decisions are often made within minutes.

Any SBLA-type program would have to be cognizant of, and preserve, these features, as well as particular concerns of lessors: The industry is funded by asset-backed securities, and many leases are securitized through third parties, many of whom own or administer lease contracts on a pooled basis. Furthermore, lease contracts require not only repayment of the lease on schedule, but adequate maintenance and insurance of the equipment in question. These things are important because they affect the value of the equipment, which reverts to the lessor in the case of default. The definition of default under a SBCL program would have to take such issues into account.

The following are the key suggestions to emerge from the focus group:

- Lessors would have to meet certain financing criteria and have a three-year track record in the business before becoming eligible for the program.

[2] The Conference Board of Canada, *What's New in Debt Financing for Small and Medium-Sized Enterprises*.

- Industry Canada would have the power to approve lessors based upon these criteria.

- An electronic-based registration, payment and balance tracking schedule would allow for the speed and low cost that the industry requires in order to be able to fill government reporting requirements economically.

- The maximum guarantee amount for all SBLA loans and SBCL leases with an eligible SME would remain at $250,000, including a 2 percent registration fee.

- Repayment should begin within 12 months but flexible and irregular payment patterns should be allowed. The lessee should sign off on the repayment schedule at the time of the contract signing (in lieu of giving a promissory note).

- 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. The "fixed spread" will have to exceed the 3 percent currently used by the SBLA, because the real transaction cost to a leasing company is normally greater than that. Pricing is a key area of difference between lenders and lessors, so it is difficult to apply traditional banking terminology to the leasing business.

- Focus group participants agreed that the SBLA guidelines for loan eligibility could be duplicated under the SBCL.

- Research suggests that lease loss rates are somewhat lower than conventional loan loss rates. The focus group believed, further, that SBLA default remedies were directly applicable to the projected SBCL program, providing, as explained above, that the definition of "default" is revised to include failure to adequately maintain or insure the equipment in question.

Economic Impact Studies

Recent Experiences with the SBLA:
Economic Impacts, Incrementality and Risk Profile Analysis

1994

This study was done by George Haines and Allan Riding of Carleton University, and completed for Industry Canada in August 1994. It provided a benchmark for the program's incrementality in the period of the greatest growth in program lending in the SBLA's history. This benchmark can compared with incrementality after the program began moving toward cost recovery in April, 1995. The study used bank data and borrower surveys to determine the profile of firms using the SBLA, what they were using the money for, and how the 1993 changes were affecting the program's use. The authors attempted to measure the incrementality of loans made under the program, and to project changes in the default rate caused by the 1993 rule revisions.

Haines and Riding found that the average SBLA borrower was precisely the kind of firm the program was meant to target: younger, smaller firms with fewer assets, less equity, and lower profits than non-SBLA borrowers. Most loans under the program were used to buy new equipment or to finance property or workspace, resulting in increased sales, cost reductions, and avoidance of failure for the firms involved.

On the other hand, the study also found that between 30 and 40 percent of the loans granted under the SBLA were not incremental. In other words, they would have been granted regardless of the existence of the program. In the case of 30.3 percent of the firms, for instance, lenders charged lower interest rates than they charged other firms of average risk. Almost 40 percent of SBLA paid "lower than median rates" on non-SBLA loans from the same lender, indicating that there was no real need for their SBLA status.

Moreover, the 1993 amendments, in increasing eligibility to larger firms, also increased the likelihood of default. This is largely because, according to Haines and Riding's study, firms with annual sales of $2 million to $5 million were more likely to default than smaller or larger firms. The study concluded that the default rate for these firms would be 14.5 percent higher than for other firms, resulting in a correspondingly higher default rate for the program.

The Small Business Loans Act: Economic Impacts

1994

This was an econometric study prepared by C.A. Sonnen of Informetrica, in October 1994. Two econometric models were developed by Informetrica to attempt to project the future macroeconomic impact of the SBLA through 1998.

The study concluded that the overall macroeconomic impact of the SBLA, using indicators like the Gross Domestic Product, would be small. The models predicted that income and other “real” effects would increase modestly over time due to the program. The author notes that the advantage of an SBLA-type program over other possible government options in stimulating the economy is that it helps establish a knowledgeable, entrepreneurial population within the economy.

The models *predicted* that roughly 10,000 jobs per year would be created due to the SBLA loans. (Later studies measured *actual* job creation.)

Impact of SBLA Lending:
An Evaluation of the Economic Impacts of the SBLA Program

1996

This study was done by Allan Riding of Equinox Management Consultants Ltd. for Industry Canada, and was completed in December 1996. Its intention was to examine SBLA lending activity, terms of credit, and economic impact (specifically, job creation, effects on the firms' performance, and firm survival). Data from 189,000 borrower registration forms and a telephone survey of 682 borrowers were analysed to this end.

The study concluded that most SBLA borrower firms were younger (45 percent were less than one year old at the time of the loan) and smaller (over 74 percent have fewer than five employees at the time of the loan) than non-SBLA bank borrower firms.

Most loans were used to buy equipment. Approximately 45 percent of borrowers also borrowed funds to cover the SBLA fees, indicating that these are considered to be significant.

Riding concluded that roughly 54 percent of the loans made under the SBLA were incremental, where 'incremental' is defined as lending that would not otherwise have been approved at all to new firms, young firms, established firms that were unable to access debt capital for any reason, or firms in distress. However, 5 percent of firms were found to have benefitted directly from the SBLA in having their loans approved and concluded expeditiously, and 75 percent indicated that it was responsible for a greatly improved relationship with their lenders. In total, Riding estimated that these more liberal interpretations of incrementality would see up to 86 percent of SBLA lending as incremental.[3]

SBLA borrowers anticipated that their loans would enable them to create between 2 and 3 jobs per borrower. In fact, actual hiring due to the loans was found to be higher: 3.9 people per firm per loan.

Incremental hiring – that is, hiring that would not have taken place absent the SBLA – was estimated to amount to 121,000 jobs in 1995, or 350,000 jobs between April 1993 and December 1996.

The study found that most SBLA borrower firms saw their sales and profit increase, and, in some cases, their very survival assured, due to the SBLA loans.

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[3] Allan Riding, *Cost-Benefit Scenarios for Loan Guarantees* (Ottawa: Equinox Managing Consultants, Inc., 1998), p. 30.

The Current Market for Small Business Financing

1998

This study was completed for Industry Canada by Roy Norton in April 1998. Its purpose was to examine the debt financing market for SMEs since the 1995 changes to the SBLA, to identify gaps in SME financing, and to assess whether the SBLA unnecessarily duplicates other financing programs.

Norton concludes that recent debt financing innovations have come in areas where the SBLA has chosen not to participate, such as working capital or leasing. Other new debt financing instruments have targetted specific sectors – export or knowledge-based industries. In short, the majority of new initiatives meet the debt financing needs that the SBLA is least qualified to address.

The gap in debt financing that the SBLA was created to fill, however – the need for financing for firms that are new, or young, or small, or without a financial track record – continues to be one that the SBLA successfully occupies, without significant duplication or redundancy. While there are other mechanisms for SMEs to obtain debt financing, in the absence of the SBLA it is these small, young, general sector firms that would typically find themselves without necessary financing.

Norton found that other federal and provincial programs tend to be targetted to specific types of firms or to lack the simple, flexible, non-bureaucratic nature of the SBLA that has made it such a successful program.

One of the most persistent gaps continues to be the need for working capital. Norton maintains that, while the SBLA does not address this need directly, it does provide new or young firms with a form of credit credibility, while requiring little collateral, so that these firms can turn to other sources for working capital loans. Other gaps also remain problematic, notably that of knowledge-based industries, which have less need for the sorts of fixed-asset loans the SBLA provides so efficiently.

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

1998

This study was prepared for Industry Canada by Pierre Vanasse and Kimberley Birkbeck of the Conference Board of Canada. It was completed in June 1998. Its purpose, as the title indicates, was to assess the usefulness of the SBLA in light of recent innovations in financial services, and the way these services are delivered. Vanasse and Birkbeck examined existing data and studies to draw their conclusions, which are as follows.

The SBLA has been successful at achieving its objectives. It has helped to lend more than $20 billion to over 500,000 SMEs since its inception in 1961. Total claims against the guarantee totalled only $699 million as of March 31, 1997, meaning that over $19 billion has been successfully loaned to SMEs under the program. More than half of that money has been loaned since 1990, and two thirds of the loans have been repaid thus far.

The Conference Board study, using its own methodology, supports Alan Riding's assessment that the vast majority of loans made under the program since the 1995 changes have been incremental, and would not have been made in the absence of the program. They have been predominantly to new or young firms, firms that were having trouble finding debt financing, and firms in distress. Vanasse and Birkbeck argue that they can be seen as incremental in significant part because their fee and registration structure means that SBLA loans are more expensive for borrowers to service and less cost-effective for financial institutions to issue and approve. Therefore there is a disincentive for loans to be registered as SBLA loans and so the program is unlikely to be used by either borrowers or lenders if there is an alternative.

Vanasse and Birkbeck maintain that the SBLA continues to be viable and necessary even though financing opportunities for SMEs have burgeoned. This is because those opportunities are not aimed at the very SMEs the SBLA is intended to help: the new and very young, SMEs without a financial track record.

They argue that, while financing gaps remain in the SME sector, notably where knowledge-based industries, capital leasing, and working capital are concerned, it may not be possible or desirable for a broad-based instrument like the SBLA to attempt to fill them all. Working capital, for instance, entails different sorts of risks that the SBLA may not be well-suited to monitor. On the other hand, they accept Roy Norton's argument that the SBLA serves to a) provide a SME with a certain credibility, and b) free collateral for conventional working capital loans, so that it is, indirectly, an aide to obtaining working capital.

The authors suggest that the SBLA administration should consider taking advantage of electronic outlets to promote and simplify delivery of the program. For instance, application forms could be filed through the Internet or through the electronic banking sites of traditional banks. Further, the definition of eligible lenders might be expanded to include such Internet banking providers as ING Direct, Wells Fargo, or mbanx.

Default and Non-Compliance Studies

Small Business Loans Program:
Loan-Splitting and Other Events of Non-Compliance

1998

This study, completed for Industry Canada in May 1998 by Ernst and Young, examined 110 Business Improvement Loan (BIL) files in order to determine whether there was any evidence of non-compliance with the SBLA.

The sample selected is *not* intended to be representative of the entire BIL population. Neither its size nor methodology allow it to be statistically representative, and therefore one cannot extrapolate about its findings to the larger loan population.

The sample did include files from six financial institutions, three cities (Toronto, Ottawa, and Montreal), and were dated no earlier than the beginning of 1995. Ernst and Young believes that the sample size is broad enough to expose evidence of systemic non-compliance within the selected institutions.

Of the 110 files, eight could not be located. There were seven cases of loan-splitting (where a related group of companies obtained more than the $250,000 ceiling in BILs) or cases where a company, ineligible for an SBLA loan due to its large size, nonetheless obtained one. There were nine files with a lack of support for asset valuation. One lender charged fees on a BIL loan that were above and beyond those allowed by the SBLA. One BIL-funded asset was ineligible for that funding. Two borrowers had been asked for a personal guarantee in excess of the prescribed limit. There was one file containing insufficient evidence of the lender's due diligence. Some of these transgressions appeared on the same file, but the study does not specify how many files, in fact, contained problems.

The study contained a number of recommendations aimed at limiting future such incidents. These concern primarily clarifications of the Act for lenders and borrowers; the possibility of auditing lender files or otherwise monitoring compliance; requesting independent asset valuations; and requiring further borrower disclosure.

Estimation of Models for Forecasting SBLA Defaults
Final Report

1997

This study, performed by Equinox Management Consultants in March 1997, developed statistically-based models intended to forecast default levels – and the attendant claims – on SBLA loans. Two forecasting approaches were used.

The authors – A. Riding, G. Haines, and R. Thomas – explain that however forecasting is approached, the basis for it is rooted in historical patterns. When those patterns are erratic or unstable for any reason, it obviously limits the reliability of the forecasting on which they are based.

The study shows that, in the 1990s, defaults in Quebec have been disproportionately higher than the rest of Canada. In the early 1990s they were triple and quadruple the default rates elsewhere in the country, perhaps in keeping with the unusually high default rates of the Banque Nationale. More recently, the default rates of both the Banque Nationale and more generally within the province of Quebec have been more in line with the rest of the country, but have still been high.

The study comes to the following conclusions:

- Larger loans default with greater frequency than smaller ones. Therefore the $250,000 loan ceiling should perhaps be re-examined.

- Types of loans make a difference: loans for leasehold improvements default more frequently than other loans.

- Younger and smaller firms default more frequently than bigger, more established ones. However, since the *raison d'être* of the SBLA is to provide financing for these firms, these defaults could be offset by reducing the loan ceiling and reducing the higher defaults of larger loans.

The various forecasting techniques reveal the following:

- Roughly one-third of defaults result in claims in the same fiscal year as the default; slightly over one-third result in claims in the second year, and the remainder in the third year.

- Increasingly, claims are being made within one year of the loan registration date. The rate at which this happened has more than doubled since April 1995.

- The aforementioned increase, as well as higher rates of default since April 1995, indicate that the higher costs of borrowing through the SBLA due to the annual fees instigated in that month have changed the loan portfolio. Higher-cost borrowing tends to result in lower-quality loan portfolios, because only better-risk borrowers use cheaper means of financing. (Therefore, the same fees that have resulted in greater program incrementality have also resulted in higher default rates.)

Stakeholder Consultations

A Future for the Small Business Loans Act: Stakeholder Perspectives

1996

This review of stakeholder opinions was performed by Roy Norton and presented to Industry Canada in March 1996. Borrowers, lenders, and SBLA officials were canvassed for their views on a number of issues.

These views are summarized below.

- Respondents were not in favour of conversion of the SBLA to a Credit Insurance Crown Corporation, nor did they think it should be transferred to an existing crown corporation such as the Business Development Bank (BDC officials especially didn't want this), nor restructured along the lines of the German Development Bank, largely because the latter is viewed as inappropriate in the Canadian context. Similarly, privatization was not seen as a viable option.

- Stakeholders recommended that the SBLA continue to be run as it is, with modifications to increase efficiency. For instance, it was suggested that all lenders should have to periodically re-apply for eligible lender status, particularly if competition is expected from leasing firms. In addition, efficient claims processing was viewed as critical to a smoothly running program; to that end, respondents suggested that verification of claims should occur after payment to lenders.

- Respondents were not keen to expand the SBLA to include capital leases, although they were hard-pressed to justify its continued exclusion. They did suggest that its impact on lending volume and default rates should be considered carefully.

- Incrementality was not seen as a significant issue by these stakeholders, on the grounds that cost recovery initiatives had ensured that SMEs which were capable of borrowing money outside the program would certainly do so.

- Personal guarantees were viewed as necessary by lenders and unavoidable by borrowers.

- Lenders – and clearly borrowers – were open to a flexible approach to the question of how much of a loan should be self-financed (at present it is 10 percent).

- No respondents thought fees or premiums could or should be increased. There was, however, some interest in linking fees to loan size or to particular kinds of loans (i.e. on loans with statistically higher default rates, like leasehold improvements). Lenders were particularly keen on the idea that fees/premiums should be tailored to lender performance – in other words, to the lender's ability to maintain a strong SBLA loan portfolio.

- No lenders supported a reduction in the government guarantee level.

- Respondents maintained overwhelmingly that the next lending ceiling should not be set until more was understood about the default rate and its prime causes and factors associated with it.

- Respondents in this survey professed to be satisfied with the $5 million maximum firm size. Only a small minority wanted it lowered.

- Most respondents believed that the $250,000 loan limit is ideal.

- Borrowers strongly opposed higher interest rates. Lenders were split between those who support pricing-to-risk (higher rates for greater risks) and those who believed that higher interest does not compensate for greater risk so that no significant incremental lending would occur under such a system.

- Respondents agreed that the SBLA does not “target” particular kinds of firms very well, and many thought that it should not try to do so, including in the cases of knowledge-based firms and small exporters. Both of these firms, it was argued, would be served by an expansion of the SBLA to working capital.

- There was significant enthusiasm for enhanced SBLA start-up support, including for micro-businesses.

- Respondents believed that the SBLA works as well as it does in large part because of its simplicity, and argued that this should be maintained.

- Most respondents (many of them vehemently) maintained that working capital should not be included in the SBLA.

Sage Report on Focus Group Consultations

1998

Sage Research Corporation conducted and reported on a series of 15 focus groups with SBLA borrowers and potential borrowers between April and May, 1998. Its report was presented to Industry Canada in the summer of that year.

Focus groups were conducted with current and potential borrowers, with not-for-profit organizations, and with aboriginal businesses. The groups were given issue papers – setting out the various policy questions that Sage wanted to assess – prior to the discussion.

The report's conclusions were as follows:

Among current and potential profit-based borrowers:

- Many respondents understood little about the SBLA, and felt that the program was not well publicized or explained.

- Paperwork and administrative procedures were deemed to be reasonable.

- Most current borrowers had been asked for the maximum allowable personal guarantee as collateral for loans, and most respondents agreed that personal guarantees should be required, and that the existing rule is sound.

- Most respondents thought that maximum loan size should remain $250,000. Roughly half, however, thought that, if necessary for cost recovery reasons, the government guarantee should be only 80 percent on loans above $150,000. The other half supported the status quo.

- On the other hand, when asked what measures might be taken to meet cost recovery objectives, a majority of respondents recommended a reduction in the present guarantee rate of 85 percent. The second choice among respondents was a reduction in the maximum loan size. Least preferable was deemed a rise in interest rates for the loans.

- Respondents were split over whether to expand the program to include the financing of intangible assets for the sake of knowledge-based industries. Those opposed to the expansion cited as rationale a perception that these SMEs were more subject to failure, and therefore entailed higher risk. Those in favour of it cited the importance of the knowledge-based sector for the future health of the Canadian economy. Almost all respondents said that in the event that the SBLA is expanded to include it, the knowledge-based sector should pay for any additional costs incurred as a result.

- Most businesses wanted the SBLA to retain the financing of leasehold improvements, but thought that the purchase of existing franchises and non-arm's length purchases of going concerns could be excluded.

- Respondents were split over whether to include working capital. Those opposed argued that it represents greater risk, and expected the SBLA's default rate to rise as a result. Those in favour argued that the continued lack of availability of working capital for SMEs is an ongoing problem.

- Most profit-sector participants thought that the SBLA should not be expanded to include not-for-profit organizations, on the grounds that these were riskier ventures that would be unable to repay the loans.

Among not-for-profit respondents, the key conclusions were as follows:

- Knowledge about the SBLA was almost non-existent.

- While stating that their financing needs were similar to those of SMEs, these respondents were split over whether the SBLA should be expanded to include them. Those opposed argued a concern about exposing themselves to the sort of risk that a loan entails, maintaining that they are better off managing without them. Those in favour argued that, in many cases, not-for-profit organizations have existed for more than 20 years, and were thus a better risk than many SMEs.

Aboriginal business respondents answered as follows:

- There was little knowledge in the community about the SBLA, but wide awareness of the biggest debt financing impediment they face on reserves: lenders cannot take security for loan-financed assets on reserves.

- Access to funding was widely acknowledged to be a significant problem.

- Respondents noted that flexibility of security requirements, use of funds, and types of loans would be essential in on-reserve lending.

- Most respondents wanted an SBLA-type of program to be established that would facilitate loans to aboriginal entrepreneurs both on and off reserves. This program would have to take reserve circumstances into account and be sensitive to native needs.

- No respondents were willing to accept a continuation of the status quo. Nor were they happy with the notion of changing the Indian Act in order to permit SBLA lenders to take security on reserves.

- Most respondents thought that Aboriginal Capital Corporations (ACCs) should be accepted as eligible SBLA lenders, in large part because it was felt that they would be culturally sensitive and knowledgeable.

Small Business Loans Act (SBLA)
Stakeholder Consultation Report

1998

This stakeholder report was prepared by Judith Szabo Broadcast Consultants for Industry Canada. Its core consisted of written responses and group discussions with lenders and interested associations (such as the Canadian Taxpayers Association) between December and May 1998.

Its conclusions were as follows:

- Respondents maintained that the SBLA is worthwhile and necessary.

- Most argued in favour of on-reserve lending, but there was a split over whether Community Future Development Corporations or Aboriginal Capital Corporations should become lenders.

- Respondents did not believe that publicly funded companies should be lenders.

- Most respondents did not believe that the SBLA should expand to include working capital or knowledge-based industry lending, nor did they believe that it should be expanded to serve the not-for-profit sector or to provide enhanced start-up financing.

- Capital leasing was a highly controversial topic. The five banks and one association that were strongly opposed to its inclusion argued against it on the grounds of implementation difficulties and a high associated default rate. Those in favour (three associations, one leasing company, and one lender) argued that its inclusion would allow for additional SME financing and was therefore worthwhile.

- Respondents did not want changes in the program's administrative fee level, financing or guarantee rate, or maximum loan size. While acknowledging the high default rates associated with leasehold improvements, most did not want them eliminated from the SBLA, and suggested better definition for them in the new Act.

- All acknowledged the importance of the personal guarantee; some argued in favour of increasing it.

- It was argued that the present upper sales limit of $5 million for eligible SMEs is too high, and that SMEs at that size do not require the SBLA.

- Banks strongly insisted that they did not want any new reporting requirements or additional administrative burdens, although they favoured cost-effective electronic reporting alternatives.

- There was some interest increased information-sharing and evaluation with respect to cost-recovery and SBLA performance questions, including job creation and loan incrementality.

- They were not opposed to external audits in principle, but were divided on the idea of a certification of incrementality. They suggested that the aggregate lending ceiling calculation should use a net loan balance outstanding which includes the deduction of loan repayments and defaulted loans.

- While fraud and abuse are not believed to be widespread, stakeholders did have suggestions on how to reduce their incidence.

- Most respondents argued in favour of an interim-claim payment schedule, which would allow for interim claim payments to be made before realization of all security. Some suggestions were made on how to tighten controls.

Small Business Loans Act Success Stories

1998

This survey of SBLA borrowers was performed by David Eadie for Industry Canada and completed in July 1998. In-depth interviews were carried out with some of the respondents to the survey used in Allan Riding's 1996 study, *Impact of SBLA Lending: An Evaluation of the Economic Impacts of the SBLA Program*.

Most respondents indicated that the up-front fees and higher interest rates were not objectionable to them, but were an unavoidable cost of doing business. Most respondents said that their businesses were demonstrably more successful, in terms of sales and profits, because of their loans.

Success Stories is a compilation of individual experiences with the SBLA. They are the stories of people employed in other sectors of the economy who bought existing businesses with SBLA help, or who used the program to upgrade machinery, to buy new franchises, or to facilitate mergers. These people run fast food businesses, restaurants, vacation resorts, ad agencies, recording studios. They are carpenters and concrete experts and specialized truss manufacturers. By and large, they are people whose goods and services have found solid markets and who believe that, without the help of the SBLA, they would not be competitive and may not exist at all.

Cost-Benefit Analyses and Future Evaluations

Cost-Benefit Scenarios for Loan Guarantees

1998

This study was conducted by Allan Riding of Equinox Management Consultants, and presented to Industry Canada in May 1998. Its purpose was to determine how SBLA parameters might best be manipulated in order to allow for optimum cost recovery.

SBLA data was used to determine what circumstances most frequently accompanied loan default, and how these could be minimized in the future.

Riding warns the reader that the data and therefore the conclusions were problematic because claims and defaults were recorded by the SBLA only from 1990, and, because most loans made during this period have not reached maturity, it is not yet possible to know for certain which loans will default and why. Furthermore, to make reliable policy decisions, policy makers need to understand intimately the links between default rates and various aspects of the program, but, because key changes have been made frequently since 1990, it is difficult to be sure which program attributes have caused which default rates.

Nonetheless, Riding asserts that it is possible to identify patterns of default rates across various categories of loans, and he has used these to come to the following conclusions:

- Default frequency appears to increase with loan size. Larger loans tend to default earlier if they are going to default, and therefore involve higher claims.
- New firms default with greater frequency than more established firms. (However, it is with loans to new firms that the highest program incrementality is achieved.)
- Defaults were particularly high when borrowers used their loans for leasehold improvements and to finance the registration fee, as well as in the food and beverage service sector. (Riding specifically notes, however, that not enough information is available to limit eligibility on a sectoral basis.)
- High default rates – particularly for first-year defaults – were apparent for the period in which the SBLA loan guarantee was increased to 90 percent.
- The most recent lending sub-period (since January 1996) cannot be analysed, since the reporting lag allows up to three years for lenders to report defaults so that there is no reliable data available.

Riding's study concluded that cost recovery would be maximized were the rate of the loan guarantee to be further reduced from 85 to 80 percent. This would place more onus on the lender to be prudent in approving loans, and would reduce some of the riskier loans. The financing rate could also be increased, which would have a more direct impact on borrowers and push some of them towards alternate means of financing. Changes to the guarantee rate affect the lender more directly than the borrower, and attempt to ensure that it is the riskiest loans that are not made.

A Review of Issues Surrounding Benefit-Cost Analyses of the Small Business Loans Program

1998

This study was prepared for Industry Canada by KPMG Canada. It was completed in 1998. The study reviewed earlier economic impact studies by Allan Riding and George Haines, and by Informetrica. It provided advice on scenarios for optimum cost recovery, and for future economic impact evaluations.

The study's major conclusion was that a comprehensive understanding of the SBLA's economic impact would incorporate, in addition to the types of studies undertaken in recent years, full macroeconomic studies incorporating such indicators as Gross Domestic Product and taxes paid, as well as full social cost-benefit analyses.

Incrementality would have to be fully tested – including the measurement of which loans would not have been made without the program, as well as loan terms, financing size and scope, timeliness, and affects on lender-borrower working relationships.

The social cost-benefit analysis would include measurement of such elements as increases in productivity, quality of life and standard of living, income and job creation, economic development, and enhancement of entrepreneurial spirit, as well as defaults and claims and the administrative costs of the program.

The KPMG study does not indicate how one could presume to measure "quality of life" or "enhancement of entrepreneurial spirit", but it does note that such an approach would require "a significant investment in time and resources".

The KPMG study further reviewed four options developed by the SBLA to improve its operations and move it toward cost recovery. These include:

- BASE CASE: Changes to improve portfolio risk via improving due diligence procedures in the BIL process and tighter program monitoring, controlling interest costs and excluding the refinancing of existing leasehold improvements. This would include more information-gathering, but would occur without changes to the program parameters.

  KPMG notes that there would be some increase in administrative costs, but that these would be matched by savings from lower default rates. Lenders may have to alter their screening and credit assessment processes. The SBLA's simplicity and user-friendliness, which has been one of its chief attractions, may be compromised if the increased information required is too complex.

- Option Two: The Base Case as described above, in addition to changes in the government's liability from 90-50-10 to 90-50-12-8. These numbers refer to the decreasing percentages of a lender's portfolio of BILs that the government will guarantee. In other words, as proposed, the government would guarantee 90 percent of the first $250,000 in BILs, 50 percent of the second $250,000 in BILs, 12 percent of the next $500,000 in BILs, and 8 percent of all subsequent BILs.

  KPMG suggests that further study is necessary, as lenders may respond by restricting their SBLA loans to less than $1 million, thereby reducing access by borrowers.

- Option Three: The Base Case, plus either reducing the guarantee rate from 85 percent to 80 percent, or increase the amount an entrepreneur is expected to finance from 10 percent to 15 percent for all classes of loans (which reduces the government's coverage from its present 90 percent to 85 percent).

  Concurring with Equinox's evaluation, KPMG concludes that a change to the guarantee rate would have a relatively larger impact on cost recovery by requiring that lenders bear a greater portion of defaults. This should have the effect of requiring greater care in application assessments, and should reduce the riskiest loans.

- Option Four: In addition to the Base Case, reducing the maximum loan size to either $200,000, or $150,000, for all categories of loans.

  KPMG argues that this step would be unlikely to affect the SBLA's key target group: new and small SMEs, and that it would have the added advantage of discouraging loan-splitting, since the benefits of loan-splitting would hardly be worth the cost of incorporating several firms. On the other hand, KPMG notes that the revenue from annual registration fees would drop commensurately with the reduction in maximum loan size.

Evaluation Framework for the Small Business Loans Program

1998

This study was completed in June 1998 for Industry Canada by Price Waterhouse. Its purpose was to propose a complete evaluation package for the SBLA, including evaluation issues, performance indicators, data collection requirements, and potential methodologies and options.

The evaluation package proposes to measure the extent to which the SBLA is effective at meeting its goals, which PW defines as the following:

- increasing small business access to financing through guaranteed loans;
- minimizing the negative effects of the economic cycle; and
- encouraging the efficiency and productivity of SMEs.

As of 1995, these objectives are meant to be accomplished with a concurrent goal of cost recovery (a goal that the Auditor General has noted may not be compatible with the SBLA's main objective).

PW suggests that the main evaluation issues are as follows:

i) Does the rationale for the program continue to exist?
ii) Is the program achieving what is was intended to achieve?
iii) How effective and efficient is it?
iv) Are there alternative ways of achieving its objective?
v) What have been the effects of the various changes to the SBLA?

The package then presents the key questions and data requirements that should be answered and collected as these issues are systematically and periodically evaluated.

The study recommends that SBLA data for reporting on key areas of performance be collected on an annual basis, and that comparative data on non-SBLA loans be collected every two years. It lists which data are already collected and which additional data are required.

The study notes that collection and access to much of the data would be difficult, either because it is not available in electronic format or because, for one reason or another – privacy included – lenders would be unwilling to release it. Therefore PW recommends that Industry Canada consult lenders with an eye to developing arrangements and obtaining access to these data as they are gradually collected in a usable, electronic format.

The study notes that, at present, borrower surveys are difficult to perform because of the lack of borrower telephone numbers. It suggests that Industry Canada request lenders that these be provided on the loan registration forms.

Not insignificantly, the study notes that the additional monitoring and reporting requirements will place an added burden on lenders and borrowers, as well as SBLA administrators. Price Waterhouse suggests that this impact should be further studied, as it may be problematic.

The study acknowledges that, regardless of how much data is collected, there would be significant difficulties involved in such issues as assessing the incrementality of the SBLA, attributing impacts and effects specifically and with assuredness to the SBLA, and assessing the extent to which the program is recovering its costs.

The study recommends that, ideally, a full evaluation be conducted five years after the renewal of the SBLA, and that a mid-term evaluation be conducted partway through. It outlines three levels of evaluation, the more complex two of which use more survey interviews and case studies, with increasing levels of accuracy and, of course, cost.

Synthesis

A number of salient points suggest themselves when the studies are compared and contrasted. These are as follows:

- The SBLA's average borrowers are new or young firms that would have trouble finding debt financing absent the program.

- Default rates rose significantly following the 1993 increases in eligibility (allowing larger loans to larger firms).

- Total incrementality rose after the cost-recovery-driven 1995 addition of an annual fee in addition to the one-time registration fee, but so did default rates. This is because the cost of borrowing under the program became expensive enough, for both lenders and borrowers, that borrowers only used the program if they had no cheaper choice. This has had the effect of worsening the loan portfolio as a whole. (The default picture appears, however, to have been skewed by Quebec's performance, which was considerably worse than the rest of the country for a number of years.)

- A number of studies discussed the difficulty in determining incrementality. While ideally it would be useful to know from the *lender's* perspective whether a given loan would have been granted absent the SBLA, or whether its terms would have been similarly favourable absent the SBLA, it is not always possible to do so because some lenders may desire the government guarantee for a certain percentage of their loans regardless of their risk. One study did note that the costs associated with the SBLA program since 1995 mitigate against such lender behaviour, and discourage lenders from using the program unless they believe it is necessary.

- Loans on leasehold improvements have a worse default rate than other types of loans.

- Debt financing gaps persist in the areas of loans to knowledge-based firms and export firms, and in the area of working capital, where the market appears to be making efforts to ameliorate the situation; and in the areas of loans to women, where it does not. Young entrepreneurs and aboriginals on reserves continue to be under-served by the market and by government programs.

- Studies and stakeholder consultations oppose the extension of the SBLA to backing working capital loans, on the ground that they are riskier than asset-based loans.

- Stakeholders are divided over extending the SBLA to capital leasing, although the main opposition appears to come from the banks. Studies demonstrate that extending the SBLA to capital leasing would be both equitable and relatively straightforward.

- Stakeholders are unanimous in wishing to see the SBLA preserved in its current form, without major changes. Fine-tuning is encouraged in order to solve persistent problems, but not at the cost of the program's broad-based, new-and-young-entrepreneur-focussed characteristics, nor at the cost of its simplicity.

- Economic impact studies show that the program is successful in allowing for debt funding to firms that would predominantly otherwise be unable to obtain it, and that those loans in turn have allowed those firms to increase sales, hire more employees than expected, and, in many cases, to stay afloat through difficult periods.

- One study took, and another advocated taking in future, a macroeconomic approach to examining the impact of the SBLA. This is an approach which examines its impact on Gross Domestic Product as well as certain intangibles such as "quality of life". Most studies do not advocate this approach. In large part this is because, in the seventh largest economy in the world, an average injection of a little over $1 billion/year since 1990 is by definition small.

- The more pertinent and useful questions are whether the SBLA is doing what it is intended to do, and whether it is doing it well.

- In addition to the studies and methodologies which have been used to answer these questions to date, an evaluation model has been prepared by one study which would allow for more precise conclusions to be drawn. This study warns that, even with the collection of suggested additional data, conclusions on a number of key issues would be difficult to draw. Furthermore, it warns that some of the suggested additional data would be costly and difficult to collect.

- Two studies suggested that reducing the guarantee rate from 85 percent to 80 percent would increase cost recovery. Another suggestion was that the maximum $250,000 loan ceiling might usefully be reduced, as it is the larger loans which tend to have greater default rates. With this latter approach, the SBLA's target population – new and young firms – would be least affected by the changes.