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Canada Small Business Financing Act

Comprehensive Review Report

2004-2009

Canada

This publication provides a review of the operations of the Canada Small Business Financing Program from April 1, 2004, to March 31, 2009.

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1. Preface

As legislated by the *Canada Small Business Financing Act* (CSBFA) of 1999, the Canada Small Business Financing (CSBF) Program operates on a statutory five-year review cycle. This report covers the second such review period, from April 1, 2004 to March 31, 2009.

This review draws largely from an in-depth third party evaluation of the program, which is governed by a results-based management and accountability framework (RMAF). The review examines:

- the extent to which the program is meeting its objectives;
- the rationale and relevance of the program in meeting small and medium-sized enterprise financing needs; and
- possible program improvements.

2. Executive Summary

Small and medium-sized enterprises (SMEs), which account for nearly 98 percent of all businesses in Canada,[1] are significant drivers of economic growth and productivity. To realize their full potential, SMEs require a favourable environment in which to grow and prosper. Access to sufficient and appropriate financing is a critical element for SMEs to succeed in the marketplace.

The *Canada Small Business Financing Act* (CSBFA) was created in 1999 as the successor to the *Small Business Loans Act* (SBLA), which had helped small businesses obtain debt financing since 1961. The CSBF Program aims to increase the availability of financing for the establishment, expansion, modernization and improvement of small businesses. Under the CSBF Program, Industry Canada and commercial lenders share the risk of providing small businesses with term loans for acquiring real property and equipment and making leasehold improvements. The Minister is liable to pay 85 percent of eligible losses on defaulted loans registered under the program. By sharing the burden of risk on loans, the Government of Canada and private sector lenders are able to increase the amount of financing extended to small businesses.

The overall purpose of the current review is to examine how successful the CSBF Program has been during the past five years of operation in facilitating small business' access to financing. Specifically, the review considers the degree to which the program has achieved its two objectives:

(1) Incrementality — the extension of financing that would otherwise have been unavailable to small businesses, or available only under less favourable terms; and

(2) Cost recovery — the ability of program revenues (in the form of fees paid on loans over the life of the loans) to offset its associated cost of claims.

A significant number of background studies were prepared in support of the review, including an independent program evaluation conducted under the direction of a public–private sector committee in accordance with the program's results-based management and accountability framework.[2] Research conducted in preparation for the Comprehensive Review is listed in Appendix A. Reports are also available at the **CSBF Program Research and Studies** web page (www.ic.gc.ca/eic/site/csbfp-pfpec.nsf/eng/h_la00041.html).

Key findings from the research are as follows.

Program Rationale

- There is an ongoing need for facilitated access to asset-based debt financing for small businesses, particularly for start-ups and businesses operating in higher risk sectors.
- There are no attractive alternatives to a federally managed program along the lines of the CSBF Program.
- Lenders believe that the CSBF Program has a role to play and does indeed make financing available to firms that would otherwise be denied.
- The recent downturn in the global economy has increased the importance of programs such as the CSBF Program, which provide affordable sources of financing to SMEs.
- The CSBF Program is consistent with both Departmental and government-wide priorities.

[1] Industry Canada. *Key Small Business Statistics*, July 2009.
[2] KPMG. *Evaluation of the Canada Small Business Financing Program*, 2009.

Program Activity and Benefits

- During the review period, the CSBF Program registered approximately 48 000 loans with a value of nearly $5.1 billion.
- Program usage declined from 11 143 loans, worth $1.04 billion, in 2004–05 to approximately 7850 loans worth $900 million in 2008–09.
- Loans made under the CSBF Program were highly incremental:
  - Approximately 54 percent of CSBF loans went to new or start-up firms; and
  - 80 to 85 percent of the loans were financially incremental[3] (i.e., they would not have been made, would have been made for a lesser amount than sought by the borrower or would have been made under less favourable conditions).
- An analysis of changes in employment growth between CSBF firms and comparable SMEs found that in the five subsequent years after receiving a CSBF loan, firms using the program were able to retain an average of 18 600 more employees than comparable SMEs.
- The 2008 Longitudinal Economic Impact Study of the CSBF Program found that CSBF Program loans delivered major economic benefits, including:
  - Higher levels of sales growth for CSBF Program borrowers than for non-CSBF Program borrowers (11–24 percent higher for each year during the four-year study period);
  - Higher employment growth than other firms (5–9 percent higher);
  - Higher investment growth than the comparison group (ranging from 14.5 percent to 68.0 percent vs. 15.0 percent to 59.1 percent annually);
  - Higher average and total sales growth than their peers (35.8 percent vs. 33.0 percent, and 28.5 percent vs. 15.9 percent respectively); and
  - Slightly higher business survival rates than for non-borrowers (ranging from 70.9 to 93.5 percent compared to 69.7 and 91.7 percent annually).
- Analysis of the costs and benefits of the CSBF Program indicate the presence of significant benefits to Canadian society. Based on a nine-year time frame analyzed, from 1999–2000 to 2007–08, total costs of the program were estimated to be $728.5 million whereas total benefits were $5598.2 million, resulting in total net benefits of $4869.7 million.[4]
- Benefits have been realized throughout Canada. During the period under review, borrowers residing in rural areas accounted for 17.2 percent of total CSBF Program lending by value.

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[3] Canada Works Limited. *Canada Small Business Financing Program: Updated Analysis of Incrementality*, 2009.
[4] KPMG. *Study of the Economic Costs and Benefits of the Canada Small Business Financing Program*, 2009.

Cost Recovery

- As at March 31, 2009, the net cost to government of CSBF Program loans made during the reporting period is estimated to be $150.4 million on a net present value basis over the maximum ten-year life of the loans. This estimate is derived by forecasting net revenues, from fees paid by lenders and borrowers to the Crown, and deducting forecasted claims from loan losses for which the government must pay.
- Compared to the first five-year lending period of the CSBF Program, the overall net cost to government (as a percentage of total lending) has increased from 2.6 percent to 3.9 percent.
- While the program is not fully cost-recoverable when strictly using revenues from the administration and registration fees it charges, it is cost-recoverable when additional federal income taxes and GST remittances from CSBF borrowers are considered. Since 1999–2000, additional federal income tax remittances resulting from incremental salaries and wages being paid by CSBF Program firms averaged $39 million each fiscal year while GST remittances averaged $24 million annually.[5]
- A 2002 report by the Auditor General, as well as the third-party evaluations carried out in 2004 and 2009, have concluded that full cost recovery could not be achieved without unduly compromising the program objective of facilitating financing to small businesses that would not likely obtain it otherwise.

Program Administration

- While financial institutions recognize the value of the CSBF Program, they have consistently expressed dissatisfaction with the administration practices associated with CSBF Program loans. As lenders continue to implement measures to streamline (through the increased use of credit scoring) and automate lending practices, government-established practices for administrating CSBF Program loans are becoming increasingly obsolete.
- A number of regulatory and non-regulatory measures have been implemented since the 2004 CSBF Program Comprehensive Review Report, in an effort to simplify delivery functions, improve communications with lenders and decrease administrative burden. These improvements were made without altering the program's key parameters. While these measures have improved some areas of program administration, lenders continue to cite a lack of profitability and continued administrative burden as the key barriers to program usage.
- Administrative burden must be addressed by modernizing the design of the CSBF Program (with due consideration given to accountability to Parliament and the needs of lenders and borrowers) in order to ensure the long-term viability of the CSBF Program as an affordable source of financing for SMEs.

Undoubtedly, SMEs will continue to play a key role in Canada's economic growth while continuing to face challenges in accessing the financing they need to do so. This review confirms the importance, efficiency and effectiveness of the CSBF Program in helping address these challenges. It concludes with a commitment to strengthen stakeholder relations and develop a package of changes aimed at addressing stakeholder concerns and modernizing the CSBF Program, thereby securing its continued success.

[5] KPMG. *Study of the Economic Costs and Benefits of the Canada Small Business Financing Program*, 2009.

3. Small Business Financing Challenges

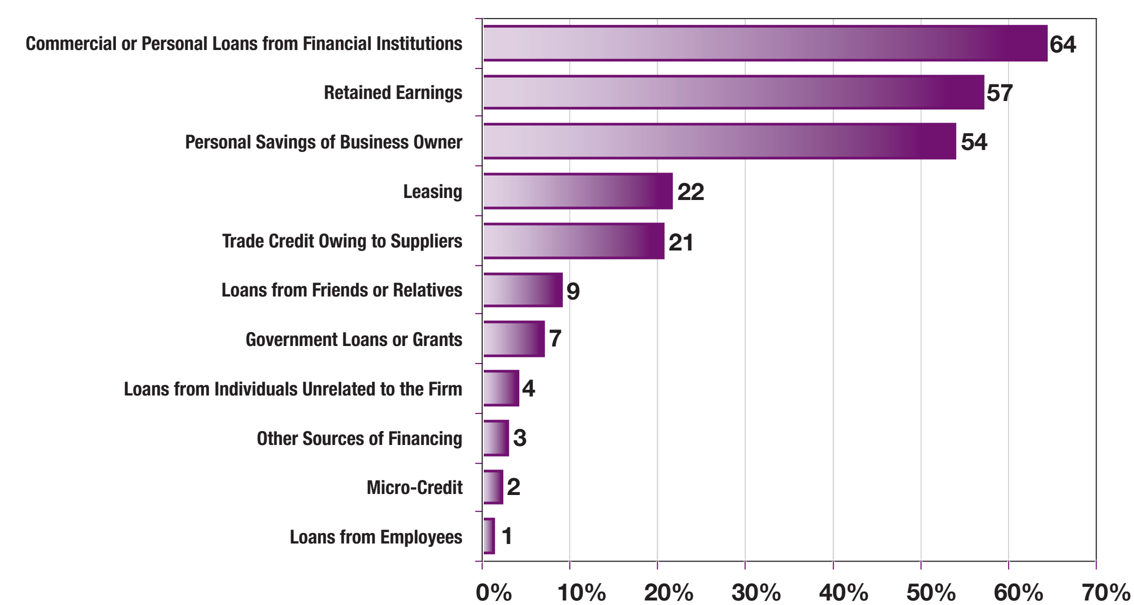
3.1 Small Business and the Financial Marketplace

SMEs account for the majority of businesses in Canada and drive job creation, productivity and growth in the economy. In 2008, there were nearly 1.1 million employer establishments[6] in Canada, 98 percent of which have fewer than 100 employees, 75 percent have fewer than 10, and 55 percent have only one to four employees.

In 2008, small businesses had more than 5.2 million paid employees, or roughly 48 percent of the private sector labour force. These enterprises accounted for the creation of over 100 000 jobs, or 40 percent of all jobs created in Canada. In addition, in the previous decade small businesses accounted for 37 percent of all jobs created in the private sector.

On average, between 2002 and 2007, more than 130 000 businesses entered the Canadian marketplace each year. These businesses must have access to capital to become established and grow. Their capital starts with personal savings and investment by family and friends and can come to include loans, lines of credit, retained earnings and other sources of financing. Figure 1 reveals the types of financial instruments used by SMEs in 2007 on total borrowings of $50 billion.[7]

Figure 1: Types of Financial Instruments in Use by SMEs in 2007



The vast majority of small businesses meet their financing needs through market transactions without any government involvement. Most turn to debt financing at an early stage of development. Banks are approached the most often, with 68 percent of small businesses approaching banks for their latest financing request in 2007. Trust companies, credit unions, Caisses populaires and other institutions play a smaller but important role.[8]

6 Employer establishments are those businesses that maintain a payroll of at least one person.
7 Statistics Canada. *Survey on Financing of Small and Medium Enterprises*, 2007.
8 Statistics Canada. *Survey of Suppliers of Business Financing*, 2007.

Financial institutions have strived to improve their service to small businesses. Many have developed product offerings specifically tailored to meet small business financing needs (e.g., commercial credit cards). They have also taken action to speed up credit decisions through the application of information technology. So-called credit scoring permits institutional lenders to reduce the transaction costs of high-volume, low-value loans, expanding the number of small business clients that can be profitably extended credit.

3.2 Current Environment and Financing Challenges

A global economic slowdown began in the third quarter of 2007, and the Canadian economy entered a recession in the fourth quarter of 2008. As economic conditions deteriorated, financial institutions became increasingly reluctant to lend to those businesses that were deemed to be higher risk. Certain types of businesses, including most CSBF Program borrowers, represent greater risk to lenders and investors than others. They include start-ups with little or no credit history and firms with few tangible assets to secure a loan. Moreover, enterprises engaged in developing new products and services can encounter lenders or investors with comparatively little knowledge of the business and corresponding perceptions of high risk. These factors and others help to explain why 51 percent of small businesses use commercial or personal loans to start up, compared to 64 percent of businesses that used this type of financing once they are established.[9]

Size of firm is also a major determinant of a business' financing profile — both start-ups and established smaller firms make more use of "informal" financing, including loans from friends and family, than do other businesses. Larger, more established firms are more likely to successfully obtain commercial loans, mortgages, lines of credit and other "formal" types of financing.

Obtaining relatively small sums of money for small business financing can be difficult. Notwithstanding credit scoring, some small loans often still do not justify overhead costs. Moreover, a report from a 2007 survey by the Canadian Federation of Independent Business emphasized that relationships between loan managers and their clients had a strong influence on loan application success rates — the higher the turnover rate of account managers at a financial institution, the higher the loan rejection rate.[10]

3.3 Role of Government

Like governments in many other countries, including all of Canada's major trading partners, the government has long recognized the importance of small businesses to economic growth and well-being and that access to financing can be a critical issue for small businesses, particularly during their early years. Therefore, the government has sought to help small businesses and entrepreneurs through a variety of financing programs.

This effort includes loan programs offered by some of the regional development agencies, federally supported community futures and other local economic development organizations, and the Business Development Bank of Canada (BDC). The *Business Development Bank of Canada Act* states that as a complementary lender, BDC's "loans, investments and guarantees are to fill out or complete services available from commercial financial institutions." The BDC works in partnership with other financial institutions to create borrowing diversification: its flexible, longer-term financing supplements short-term financing available from other sources. BDC's financing is provided directly to Canadian SMEs on a commercial basis, at rates commensurate with the higher degree of risk assumed by the BDC.

The CSBFA was developed on the premise that there are many small businesses in Canada whose financing needs are not being met by traditional private sector lending and that there remains a public policy rationale

9 Statistics Canada. *Survey on Financing of Small and Medium Enterprises*, 2007.
10 Canadian Federation of Independent Business. *Banking Matters*, 2007.

for government to help fill marketplace gaps. The CSBF Program is unique in that it is available to small businesses throughout the country through more than 14 000 points of service operated by private sector financial institutions. At the time of enactment, the CSBFA was considered to be highly relevant to the needs of small businesses and, overall, an efficient, effective and simple mechanism to facilitate debt financing for emerging and established small businesses.[11] It has been subsequently confirmed that there are no attractive alternatives to a federally managed program along the lines of the CSBF Program and that there is minimal overlap between it and other federal initiatives to support access to financing by small businesses.[12]

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11 Industry Canada publication prepared in conjunction with the 1998 Parliamentary Review of the *Small Business Loans Act, Access to Financing for Small Business: Meeting the Changing Needs*, 1998.

12 KPMG. *Evaluation of the Canada Small Business Financing Program*, 2009.

4. Overview of the *Canada Small Business Financing Act*

The CSBFA aims “to increase the availability of financing for the establishment, expansion, modernization and improvement of small businesses.” It replaces the former *Small Business Loans Act* (1961), received Royal Assent on December 10, 1998, and came into effect for loans made after March 31, 1999.

Under the CSBF Program, Industry Canada and commercial lenders share the risk of providing small businesses with term loans for acquiring real property and equipment and making leasehold improvements. The Minister is liable to pay 85 percent of eligible losses on defaulted loans registered under the program. By sharing the burden of risk on loans, the Government of Canada and private sector lenders are able to increase the amount of financing extended to small businesses.

4.1 Program Objectives

One of the key objectives of the CSBFA is to increase the availability of financing for small businesses. This objective of extending financing that would have otherwise been unavailable, or would have only been available under less favourable terms (higher interest rates, greater collateral requirements, etc.), is commonly referred to as “incrementality.”

The other main objective of the program is “cost recovery.”[13] This essentially refers to revenues generated by the program in the form of fees paid on the loans in a given year, offsetting the total claims paid on those loans over their term (up to a maximum of 10 years).

It is important to note that program objectives are contradictory in nature, as achieving full cost recovery would significantly decrease the degree of incrementality, and vice versa. The challenge is to have the program achieve a relatively high level of incrementality while, at the same time, maintaining an acceptable level of cost recovery. The fact that full cost recovery under the CSBF Program is not expected to occur was raised in the 2005 Comprehensive Review of the program and was reviewed by Parliament at that time.

4.2 Program Parameters

It should be noted that only businesses[14] with annual revenues of $5 million or less are eligible to use the program. Details on other key parameters of the CSBF Program are listed in Appendix B.

The parameters are interrelated, which is to say that modifying one can impact on others. In addition, changing the parameters can involve trade-offs between the degree to which the program’s policy objectives of incrementality and cost recovery will be achieved.

4.3 Program History

Through the CSBF Program, and its predecessor, the Small Business Loans (SBL) Program, Canada has nearly 50 years of experience with facilitating debt financing for small businesses through an innovative public–private partnership. The program has helped establish and grow some half-million Canadian businesses that have received cumulative private sector financing worth some $35 billion.

13 Cost recovery does not include Industry Canada’s operating costs (approximately $3 million per year) associated with administering the program.

14 Businesses involved in farming and businesses having as their principal objective the furtherance of a charitable or religious purpose are excluded from the program.

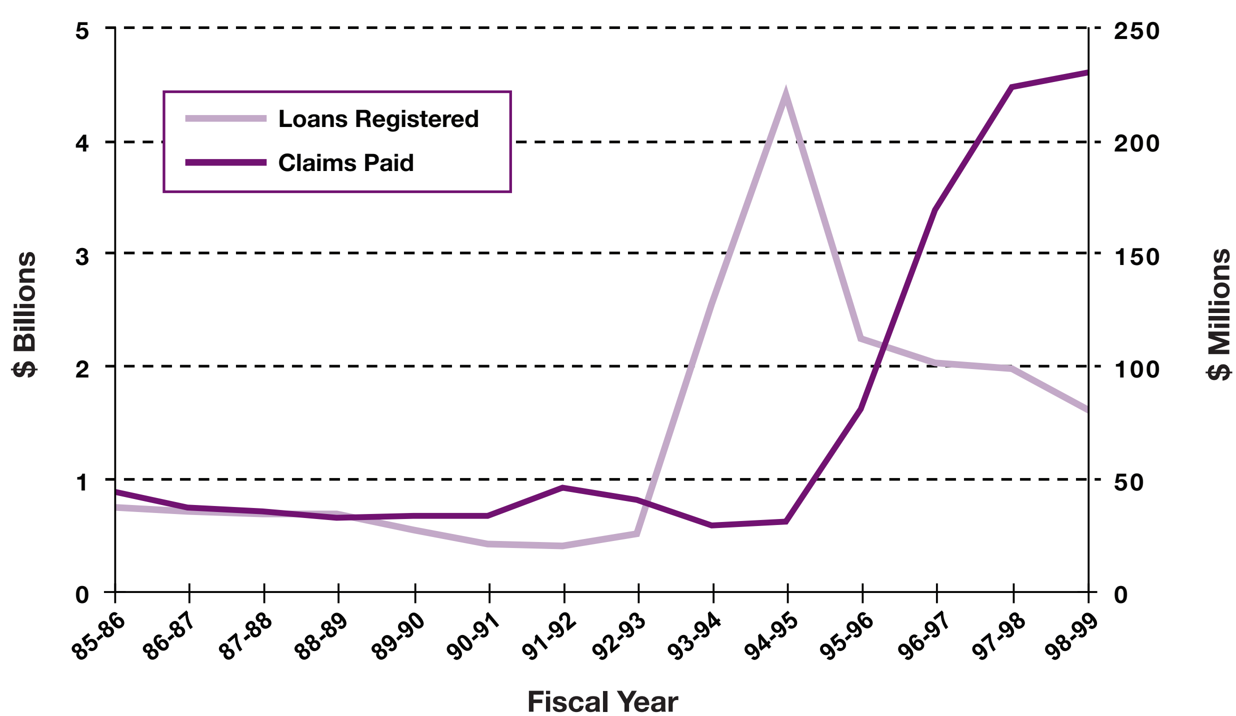
Small businesses seeking a loan under the program have always needed to apply directly to any approved or designated financial institution, such as a chartered bank, trust company, Caisse populaire or credit union. Lending institutions evaluate the creditworthiness of an applicant, with the same diligence applied to any other loan application.

If the lending institution agrees to extend credit, the lender can choose to register the loan with Industry Canada, which is responsible for accepting the registration from the lender provided it meets the eligibility requirements under the Act. Where registered loans go into default and claims for a loan loss have been made, the government absorbs part of the loss (currently 85 percent, after recoveries on security).

The program has evolved over time in response to changing conditions in the marketplace and the evolving needs of small businesses. For example, the maximum loan size started at $25 000, reached $100 000 by 1980, was increased to $250 000 in 1993 and remained at this level until the end of the current review period (March 31, 2009). The maximum loan size was again increased on April 1, 2009 to a maximum of $500 000 (of which no more than $350 000 can be used for leasehold improvements and equipment purchases). Fees and charges to borrowers and lending institutions using the program have also varied over time.

In response to the recession of the early 1990s, the program parameters were significantly broadened. For example, the government's loss-sharing ratio was raised from 85 to 90 percent. The result was significant growth in program activity between 1993–94 and 1994–95. Lending increased from a norm of about $500 million annually to a peak of $4.4 billion in 1994–95. At this time a 1.25-percent annual administration fee was introduced and some of the changes were reversed in an effort to begin moving the program toward cost recovery. This spike in uptake was followed by a spike in claims for loss. The total value of claims rose to peak at $230 million in 1998–99. Figure 2 displays the relationship between program changes and growth and claims up to the end of 1998–99, when the SBLA was repealed.

Figure 2: Changes in SBL Program Lending and Claims from 1985–86 to 1998–99



While these changes resulted in a significant decrease in program lending, they also helped re-establish a more sustainable balance between program costs and expenses.

Capital Leasing Pilot Project (April 1, 2002–March 31, 2007)

In 2002, Industry Canada launched a five-year pilot project to identify and test the viability and utility of the CSBF Program for capital leasing. There was a low participation rate with about 1500 leases worth $136 million being registered over the five-year pilot project. This uptake was less than 7 percent of expected activity.

Moreover, research shows that in 2007, 17 percent of SMEs sought capital lease financing and, of these firms, 92 percent had their application authorized. This research and the results of the pilot project have shown that the vast majority of Canadian small business' capital leasing needs are being met in the marketplace without government assistance. As such, the Capital Leasing Pilot Project was discontinued on March 31, 2007.

4.4 Changes to the CSBF Program Announced in Budget 2009

In response to the recession, which began in late 2008, the Government of Canada announced Budget 2009: Canada's Economic Action Plan. One of the initiatives was to support small business growth through the implementation of changes to the CSBF Program. As a result, the following changes to the CSBF Program were enacted as of April 1, 2009:

- The eligible loan amount was increased from $250 000 to $500 000 (of which no more than $350 000 can be used for purposes other than the purchase of real property);
- Financial institutions with a portfolio above $500 000 are allowed to claim reimbursement on losses of up to 12 percent of the value of their portfolio, up from 10 percent; and
- A package of regulatory amendments aimed at easing the administrative burden of the program was implemented.

5. Performance Review

5.1 Approach

A number of research studies and ongoing internal analyses were carried out by or for Industry Canada to inform the review of the CSBF Program. They can be grouped into the following categories:

- ***Program evaluation:*** An independent program evaluation was carried out under the direction of a public–private sector committee, based on a results-based management and accountability framework (RMAF) that Treasury Board recommends be used for assessing major policies, programs and initiatives. The RMAF identified key questions for the evaluation, including the program rationale, incrementality, cost recovery, economic impact, and program efficiency and effectiveness.
- ***Economic impact and benefit:*** Studies were undertaken on the program's incrementality, longitudinal economic impact and cost-benefit.
- ***Cost recovery:*** Borrowing, defaults and claims experiences of SBL and CSBF Program borrowers were compared. Cost recovery forecasts based on various statistical models were carried out and subsequently updated with the latest information. A risk and revenue analysis of the portfolio's changing characteristics was also conducted.
- ***Stakeholder discussions and surveys:*** Meetings were held with representatives from financial institutions to discuss working experience with the program and possible improvements. A borrower awareness and satisfaction survey was conducted, and lenders and borrowers were interviewed regarding their experience with CSBF Program loans as part of the program's evaluation.

Reports from this research are listed in Appendix A, and can be found at the **CSBF Program Research and Studies** website (www.ic.gc.ca/eic/site/csbfp-pfpec.nsf/eng/h_la00041.html).

5.2 Program Activity

Between 2004–09, the CSBF Program supported nearly $5.1 billion in loans to approximately 48 000 small businesses. The average loan size during this period was $105 700.

The value of annual lending declined by 13 percent over this period, from about $1.04 billion in 2004–05 to slightly over $900 million in 2008–09. The number of loans decreased proportionately more, from 11 100 to 7800, or by 29 percent. Consequently, the average annual loan size increased, from $93 500 in 2004–05 to $116 800 in 2008–09.[15]

Reasons for the decline in lending volumes include a decrease in the demand for debt financing over the five years,[16] increased use of flexible commercial lines of credit and credit cards by small businesses, an increase in the relative importance of service sector and research and development (R&D)-intensive firms using sources of financing other than asset-based debt, and administrative burden on lenders and borrowers using the program.

Start-up firms less than one year old accounted for 54 percent of the five-year total number of CSBF Program loans, and 60 percent of their value. This compares with 50 percent and 57 percent, respectively,

15 The average loan size in 2004–05 was approximately $93 500. Adjusting only for inflation suggests the average loan value in 2008–09 would be about $102 000.

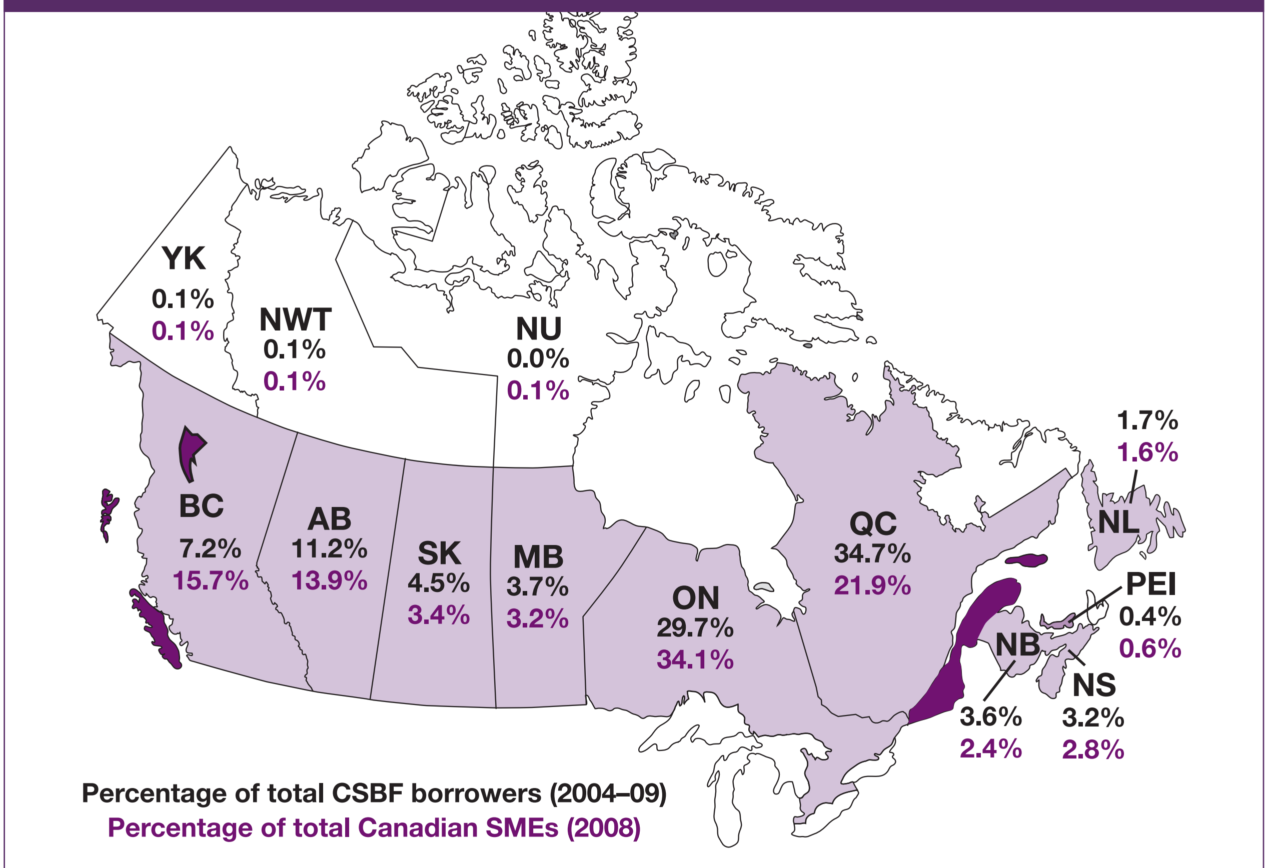
16 KPMG. *Evaluation of the Canada Small Business Financing Program*, 2009.

during the previous five years of the CSBF Program. In view of the greater difficulties experienced by start-ups in obtaining financing discussed earlier in Section 3 (because they often lack both the collateral and experience to make them credit-worthy), this result indicates the high degree of incrementality achieved by the CSBF Program.

The program facilitated financing of small businesses in all provinces and territories. Figure 3 compares the population of CSBF Program borrowers (2004–09) to the overall population of SMEs (in 2008). It shows that in some regions the share of borrowers roughly approximated the share of SMEs located in that region (e.g., Manitoba, Nunavut and Newfoundland). Elsewhere the borrowers' share exceeded the region's share of SMEs and vice versa (e.g., Quebec and Nova Scotia).

The CSBF Program is demand-driven and does not target any particular region or sector. As such, these regional variations in program use reflect the choices made by lenders and borrowers.

Figure 3: Percentage Distribution of CSBF Borrowers (2004–09) vs. Canadian SME Population by Region (2008)



CSBF Program loans have helped support the purchase of equipment (52 percent of the five-year total value of credit), real property renovations (19 percent) and leasehold improvements (29 percent).

Other Economic Benefits

The program has resulted in substantial job creation and preservation. When changes in employment growth between CSBF Program firms and comparable SMEs were analyzed, it was found that CSBF Program firms were able to retain an average of 18 600 more employees in a given year than comparable SMEs. In addition, it was found that expenditures made by CSBF Program borrowers to acquire assets created an average of 4800 additional (supplier-related) jobs annually.[17] Job displacement impacts are unknown.

A Statistics Canada economic impact study compared CSBF Program borrowers with similar firms that were not CSBF Program clients. It confirms positive results for program users and the Canadian economy. The study demonstrated that across industries, regions, and businesses of varying size, CSBF Program borrowers showed more employment growth than other firms.

In addition, CSBF Program borrowers had:

- higher sales growth than other firms (11–24 percent higher for each year during the four-year study period);
- higher employment growth than other firms (5–9 percent higher);
- higher investment growth than the comparison group (ranging from 14.5 percent to 68 percent vs. 15 percent to 59.1 percent annually);
- higher average and total sales growth than their peers (35.8 percent vs. 33 percent, and 28.5 percent vs. 15.9 percent respectively); and
- slightly higher business survival rates than non-borrowers (ranging from 70.9 to 93.5 percent compared to 69.7 and 91.7 percent annually).[18]

A more detailed overview of program activity during the first five years of the CSBF Program, including charts and graphs, is provided in Appendix C.

5.3 Incrementality vs. Cost Recovery

The essential challenge facing the CSBF Program has been and remains ensuring appropriate support for access to financing by small, often young businesses that would not likely obtain it otherwise, while at the same time striving to recover costs.

In a 1997 report on the SBL Program, the Auditor General of Canada commented that the dual objectives of increasing the availability of loans at reasonable rates and recovering all costs need careful analysis. It was suggested that the extent to which these two objectives are simultaneously achievable be thoroughly studied, and that it was uncertain whether full cost recovery would be achieved under existing program parameters.[19]

The Auditor General's report helped inform Parliament's deliberations in the development of the CSBFA. While authority for pilot projects was provided for capital leasing and extension of the program to the voluntary sector,[20] program parameters remained unchanged. The contingent liability of the Crown to CSBF Program lenders was capped according to a declining-share formula based on the value of loans that each

17 KPMG. *Study of the Economic Costs and Benefits of the Canada Small Business Financing Program*, 2009.

18 Statistics Canada. *Longitudinal Economic Impact Study of the Canada Small Business Financing (CSBF) Program*, 2008.

19 In a 2002 Status Report, the Auditor General reiterated concern about whether the cost recovery objective would be achieved. It was considered imperative for Industry Canada to develop a better model to forecast the financial performance of the CSBF Program.

20 A pilot project for capital leasing was introduced and lies beyond the scope of this review. Consultations with the voluntary sector ascertained that debt financing supported through the CSBFA was not appropriate for the financing needs of this sector.

lender registers under the program. Measures concerning due diligence and compliance with CSBF Program administrative rules were strengthened to reduce portfolio risks and costs.

Incrementality

Within these parameters, the CSBF Program has achieved a high level of incrementality. A credit scoring model[21] developed in 2003 was used with 2007–08 survey data to determine the most recent incrementality of the program. In 2003, incrementality was estimated at 75 percent, however, since then a number of important model characteristics have increased in risk. The size of CSBF Program loan recipient firms, measured by number of employees, has decreased, as has the capacity to repay loans, measured by revenues per dollar of loan. Productivity has also marginally decreased, as measured by sales per employee, and there has been an increase in the proportion of young primary owners using the CSBF Program, from 14 percent in 2001 to 17 percent in 2007. These factors have led to increases in overall portfolio risk.

Borrowers receiving loans through the program also tend to receive longer repayment terms, allowing borrowers to spread out payments and ease stress on beginning cash flows. The amount of collateral required tends to be the same as comparable non-CSBF Program loans while interest rates charged are generally somewhat higher, owing to the increased risk of the borrower.

As such, it is currently estimated that between 80 and 85 percent of CSBF Program loans would not have been made or would have been made for smaller amounts or on less advantageous terms, if the program had not been available.

Cost Recovery

Since its inception, the CSBF Program has not been fully cost recoverable. As costs are directly proportional to the risk inherent in the CSBF Program portfolio of loans, it is not surprising that the combination of an increase in the overall portfolio risk and a downturn in the economy has led to lower levels of cost recovery.

In particular, cost recovery forecasts carried out for Industry Canada suggest lending over the 2004–09 period could translate into a loss of $150.4 million on a net present value (NPV) basis. These forecasts seek to predict the value of claims from loan losses over ten years following the year in which loans are made, net of revenues from registration and administration fees paid by lenders and borrowers to the Crown.

Relative to the last five years of the CSBF Program, the level of cost recovery has decreased. For loans made from 1999–2004, it is forecast that NPV costs will total $94 million on lending of $5.36 billion, for a net cost to government of 1.8 percent (as a percentage of total lending). Over the last five years of the CSBF Program, 2004–09, the expected NPV cost is $150 million on lending of $5.1 billion, for a net cost of 3.0 percent (as a percentage of total lending). Appendix D provides a more detailed comparison of cost recovery during the first two lending periods of the CSBF Program.

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[21] Canada Works Ltd. *Canada Small Business Financing Program: Updated Analysis of Incrementality*, June 2009.

5.4 Program Administration

A number of regulatory and non-regulatory measures have been implemented since the 2005 Comprehensive Review of the CSBF Program in an effort to simplify delivery functions, improve communications with lenders and decrease the administrative burden of the program.

Some of the non-regulatory steps taken include establishing a more proactive approach to communications with financial institutions through regular meetings to address concerns, improve processes and discuss portfolio trends and analysis. Communication efforts have also been strengthened through an increase in the quality and quantity of standardized information sent quarterly, reactivation of the quarterly bulletin, the implementation of service standards and increased discussion with lenders prior to final claims decisions being made.

The 2005 Comprehensive Review report specifically indicated the CSBF Program should make better use of information technology in the administration of the program. Since then, Industry Canada has been actively pursuing the possibility of applying electronic data and fund transfer processes to the administration of the program. The main elements of the project include providing the financial institutions with the ability to conduct online registrations through a secure web-based facility and to electronically transfer registration fees. Electronic claims processing is not being pursued at this point, given the complexity involved and the low volume of transactions. Depending upon approvals and support/commitment from the financial institutions, it is possible electronic registration and fund transfers could begin in 2010. It is expected that this project will increase efficiency, improve service delivery and reduce the paperwork burden and manual processes associated with the CSBF Program.

Amendments to the CSBF Regulations came into force on April 1, 2009 and were primarily focused on reducing the administrative burden and streamlining processes to be more in line with conventional lending practices. For example, the amendments allow lenders to apply their own loan prepayment penalties instead of being required to use complex regulated penalties, and give Industry Canada greater flexibility to work with lenders to correct appraisal errors that currently cause claims to be rejected. The amendments are in line with the Government of Canada's commitment to reduce paperwork burden and barriers to business growth.

These improvements were made without altering the program's key parameters. While these measures have made minor improvements to the program's administration, lenders continue to cite a lack of profitability and continued administrative burden as the key barriers to program usage. They suggest that some program requirements, such as those to gather and keep invoices for each loan, or rules that prohibit service fees, are inconsistent with evolving and increasingly automated lending practices in the competitive environment in which they operate. Lenders also continue to express frustration because of adjustment and rejections of claims for losses due to errors.

Administrative burden must by addressed through the modernization of the design of the CSBF Program (with due consideration given to accountability to Parliament and the needs of lenders and borrowers) in order to ensure the long-term viability of the CSBF Program as an affordable source of financing for SMEs.

Conclusions and Future Directions

This comprehensive review of CSBF Program operations from 2004–09 has demonstrated that the program continues to be a successful, efficient mechanism for facilitating asset-based debt financing to small businesses.

Due to the competing nature of the program's objectives, this review period has seen the program move toward greater levels of incrementality, while achieving lower levels of cost recovery. However, while the program is not fully cost recoverable when solely considering revenues from the administration and registration fees charged, it is cost recoverable when additional federal income taxes and GST remittances from CSBF Program borrowers are included. In addition, an analysis of the total costs and benefits resulting from CSBF Program loans has shown substantially greater net benefits to Canadian society.

The CSBF Program supports billions of dollars in new financing for small businesses, helping them to drive the Canadian economy forward; however, CSBF Program lending levels have decreased by 29 percent in number and 13 percent in value over the review period, causing concern about the future sustainability of the program, and whether access to financing for SMEs is decreasing as a result of this decline.

Most major lenders have registered a significant decline in use of the CSBF Program over the review period, with administrative burden and low lender profitability cited as the key reasons for this decline. Despite efforts to reduce the administrative burden of the CSBF Program while maintaining its core design elements and key parameters, the main causes of administrative burden still persist and are jeopardizing the future sustainability of the program.

Future Directions

In January 2010, program officials undertook consultations with representatives from the small business community and lending institutions to discuss possible changes to the CSBF Program. All stakeholder groups acknowledged that the CSBF Program remains an important product to increase the availability of funding to SMEs. However, it was reiterated that potential use of the program continues to be hindered by its current design. More specifically, financial institutions stressed the importance of bringing the CSBF Program in line with conventional lending practices for small businesses outside of the program, particularly in regards to fees, proof of purchase requirements, allowable interest rates and the use of electronic/online services. Borrower representatives highlighted the need for greater awareness among SMEs and the elimination of irritants, which may hinder access to financing.

The Government of Canada recognizes that changes along these lines would strengthen and modernize the CSBF Program, thereby securing its continued success. However, the Government of Canada remains committed to maintaining the program's core strength, the provision of a reliable program, with specific parameters, on which SMEs (particularly start-ups or young businesses and those in the food service and retail sectors) have come to rely. Any changes to increase program uptake would need to maintain a balance between all program objectives, including mitigating risks to public funds.

Industry Canada officials will look to strengthen relationships with stakeholders. In particular, they will examine means to expand awareness of the program among borrowers. A commitment to enhance efforts to increase awareness and knowledge of the CSBF Program among SMEs will ensure that individuals seeking financing will be better equipped to more actively engage financial institutions about the program. The program has received positive feedback on its recent awareness campaign, which shows further potential as a means to address the lack of awareness among SMEs, as expressed by borrower representatives during consultations.

As the economic climate in Canada improves, the ability of entrepreneurs to take advantage of emerging opportunities and develop new products and services for the marketplace is essential to economic recovery. During this time, it is important for entrepreneurs to be both aware and able to access the financing they need to start a business or to expand their current business operations. Modernizing the CSBF Program would advance the Government of Canada's objective of improving access to financing and supporting the growth of small businesses in all sectors across the country.

Appendix A: *Canada Small Business Financing Act* Research for the Comprehensive Review

Program Evaluation

Bearing Point. *Evaluation of the Canada Small Business Financing Program*, 2004.

KPMG. *Evaluation of the Canada Small Business Financing Program*, 2009.

Economic Impact and Benefit

Canada Works Limited. *Canada Small Business Financing Program: Updated Analysis of Incrementality*, 2009.

Equinox Management Consultants Limited. *Incrementality of CSBF Program Lending, Volume 1: Insights from SME FDI Data*, December 2003.

Equinox Management Consultants Limited. *Incrementality of CSBF Program Lending, Volume 2: Findings from Aligned Interviews*, February 2004.

Equinox Management Consultants Limited. *Incrementality of CSBF Program Lending, Volume 3: Findings from Survey Data*, March 2004.

Equinox Management Consultants Limited. *Sources of Portfolio Risk and Revenue Generation of the Canada Small Business Financing Program — Final Report, Phase 1*, March 2008.

Equinox Management Consultants Limited. *Sources of Portfolio Risk and Revenue Generation of the Canada Small Business Financing Program — Final Report, Phase 2*, December 2008.

KPMG. *Study of the Economic Costs and Benefits of the Canada Small Business Financing Program*, 2009.

Phoenix Strategic Perspectives Inc. *Canada Small Business Financing Program (CSBFP) Awareness and Satisfaction Survey*, 2007.

Statistics Canada. *Longitudinal Economic Impact Study of the Canada Small Business Financing (CSBF) Program*, 2008.

Cost Recovery

Riding, Allan. *Forecasting Expenses Related to SBLA and CSBFA Debt Financing Loans*, January 2005.

Stakeholder Discussions and Surveys

Canadian Federation of Independent Business. *Banking Matters*, 2007.

Circum Network Inc. *Lender Awareness and Satisfaction Survey*, June 2004.

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

Heron & Company. *Small Business Loans Administration Discussions with Financial Institutions*, June 2004.

Industry Canada. *Key Small Business Statistics*, January 2009.

Statistics Canada. *Survey on Financing of Small and Medium Enterprises*, 2007.

Statistics Canada. *Survey of Suppliers of Business Financing*, 2007.

Appendix B: Key Canada Small Business Financing Program Parameters[22]

Borrower eligibility: To ensure the program is targeted at small businesses, only firms with annual sales of $5 million or less are eligible to use the program.[23]

Loss-sharing ratio: The government shares in eligible losses after realizations on security. Its share of eligible losses for loans in default is 85 percent. Lenders are responsible for the remaining 15 percent.

Cap on claims: Each lender has a separate account of registered loans. The Government of Canada's obligation to an individual lender is to pay eligible claims (i.e., 85 percent of the eligible losses) on defaulted loans in its account, up to a maximum of the aggregate of 90 percent of the first $250 000 in loans registered, 50 percent of the next $250 000 and 10 percent of all loans in excess of $500 000.

Assets financed: Loans are restricted to financing: (1) purchase of leasehold improvements, equipment, software and real property or immovables; (2) improvement to equipment and real property; and (3) program registration fees.

Percentage of asset cost financed: The maximum amount of financing available is 90 percent of the cost of the assets.

Fees: A one-time, up-front fee of 2 percent of the amount financed is paid at the time of registration. This fee can be included in the CSBF loan. In addition, the lender is charged an annual fee of 1.25 percent on outstanding loan amounts. Lenders may pass this fee on to borrowers only as part of the interest rate charged on loans.

Maximum interest rate: The maximum floating rate is the lender's prime rate plus 3 percent (including the 1.25 percent annual fee). The maximum fixed rate is the lender's residential mortgage rate plus 3 percent (including the 1.25 percent annual fee).

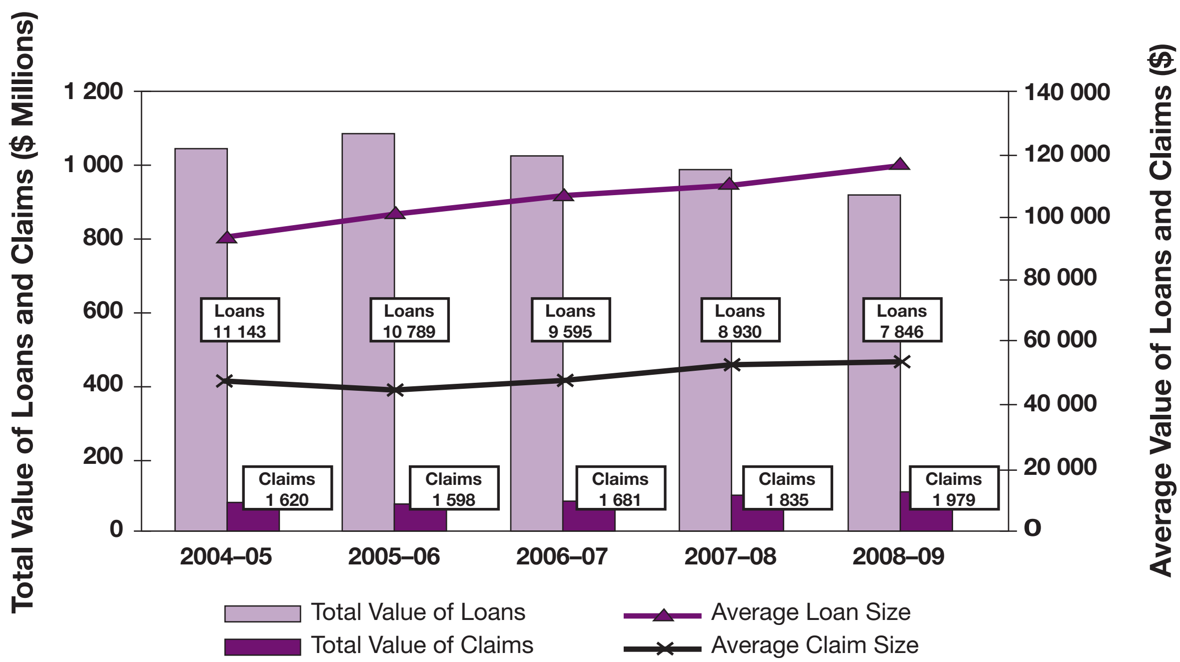
Maximum financing amount: A borrower cannot have more than $250 000 in total loans outstanding under both the SBL and CSBF programs.

[22] Program parameters listed in Appendix B are those that were in place during the 2004–09 lending period. As noted earlier in this document, changes to the cap on claims and maximum loan size were implemented as of April 1, 2009.

[23] Businesses involved in farming and businesses having as their principal objective the furtherance of a charitable or religious purpose are excluded from the program.

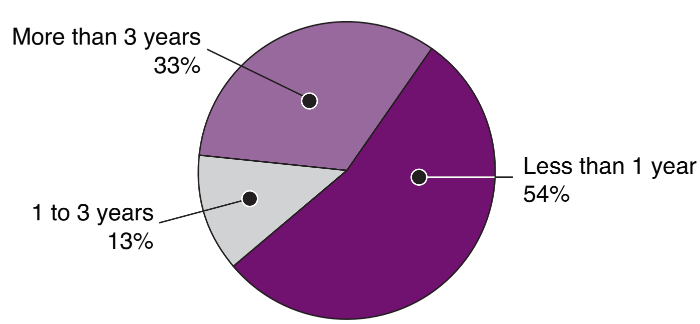
Appendix C: Canada Small Business Financing Program Activity Review

Figure C-1: Number and Value of CSBF Loans and Claims, 2004–09



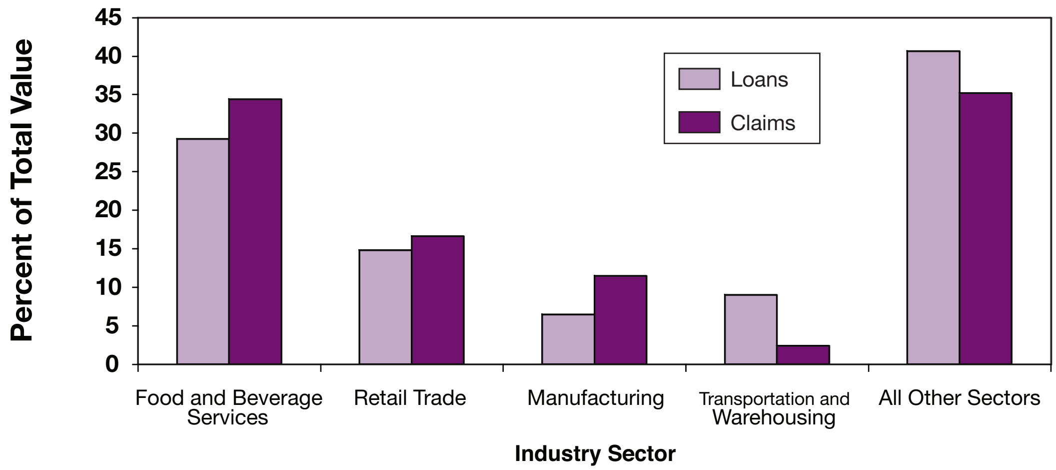
CSBF Program lending has decreased from 11 143 loans in 2004–05 to 7846 in 2008–09. Lending has also declined from $1.041 billion to $0.916 billion. Average loan value has increased from $93 500 in 2004–05 to $116 800 in 2008–09.

Figure C-2: Percentage of CSBF Loans by Age of Borrower Firm, 2004–09



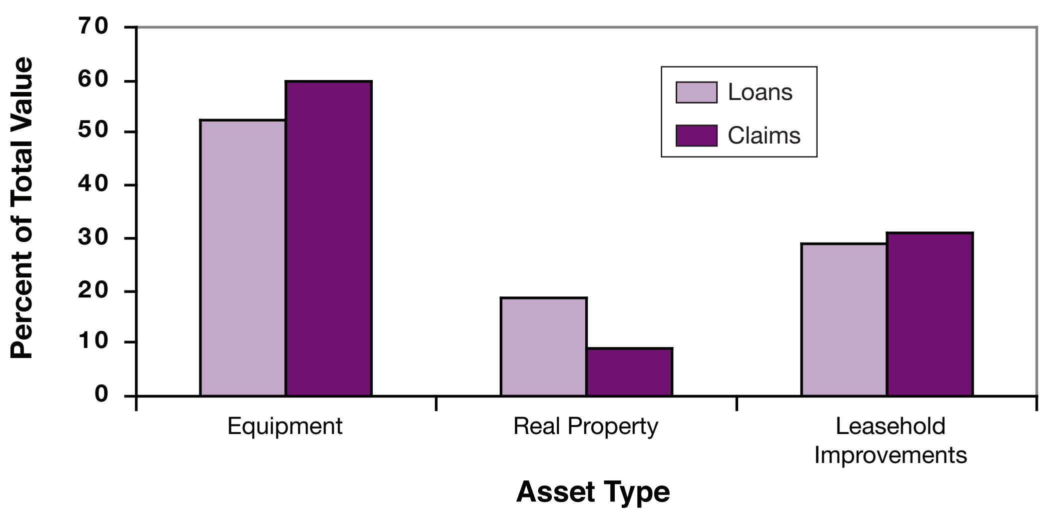
Roughly 54 percent of CSBF loans were to start-ups and businesses less than one year old.

Figure C-3: Percent of Total Value of CSBF Loans and Claims by Industry Sector, 2004–09



Four industry sectors accounted for 59 percent of the value of loans and 65 percent of the value of claims.

Figure C-4: Percent of Total Value of CSBF Loans and Claims by Asset Type, 2004–09



Over the review period, equipment loans, which account for 60 percent of claims, declined. Leasehold improvements as a percent of loans and claims both increased.

Appendix D: *Canada Small Business Financing Act* Background on Cost Recovery

In 1995, the SBL Program was given a cost recovery mandate. The importance of carefully monitoring the financial performance of the loans portfolio and regularly updating the program's cost recovery model was reinforced by the Auditor General in 1997 and 2002.

Methodology

Forecasting program revenues and costs is a complex task. First, sufficient data on loan risk and lender behaviour takes nearly four years to accumulate from the time of a parameter change. This is essential to a forecasting model. Second, the cost recovery model must cover the entire life of all loans made in a given year, which can be as much as ten years. Third, there is a significant lag time between the receipt of revenues and the payment of claims. Finally, lenders are allowed up to three years after default to submit a claim for loss, so the period can be extended to as much as 13 years. As a result, revenues and claims need to be forecast long into the future, making estimates of cost recovery difficult and subject to variance according to economic conditions and other factors. For this reason, Industry Canada updates its forecast and forecasting models on a regular basis to ensure they reflect the most recent experience.

Using a multivariate analysis of the claims received in a given month combined with statistical and econometric-based forecasting models, Industry Canada is able to project future claims[24] against the forecast revenues to arrive at the cost recovery forecast for the program.

Findings

Table D-1 below illustrates the current cost recovery forecasts for the first two lending periods of the CSBF Program (1999–2004 and 2004–09). These tables provide a summary of the revenue and expense streams associated with each of the aforementioned annual cohorts.

In aggregate, for the CSBF Program (see Table D-1 below):

- Revenues (registration and administration fees) for the five years of loans during the current review period are expected to reach approximately $281 million.
- Expenses (claims) are expected to be approximately $477 million, for a net cost of $196 million.
- Revenues are expected to offset expenses by 58.9 percent.
- From an overall loans portfolio perspective, the net cost to government is expected to reach 3.9 percent of the total loans made, up from 2.6 percent for loans made during the C1 (1999–2004) period.

[24] Riding, Allan. *Forecasting Expenses Related to SBLA and CSBFA Debt Financing Loans,* January 2005.

Table D-1

Cost Recovery Model Summary: CSBF Program Period C1 (1999–2004) and Period C2 (2004–09)

($ Millions)		Revenues and Expenses				% Cost	Net Cost/
Cohort	Loans	Reg Fees	Admin Fees	Claims	Net Cost	Recovery[1]	Loans (%)
1999–2000	1352.3	26.8	**48.5**	**-118.7**	**-43.5**	**63.4**	**-3.2**
2000–01	1159.0	22.9	**42.1**	**-101.0**	**-35.9**	**64.4**	**-3.1**
2001–02	899.2	17.8	**31.8**	**-66.1**	**-16.5**	**75.0**	**-1.8**
2002–03	951.2	18.8	**31.8**	**-65.5**	**-14.9**	**77.3**	**-1.6**
2003–04	999.9	19.8	**31.2**	**-79.1**	**-28.1**	**64.5**	**-2.8**
Total (1999–2004)	5361.6	106.1	**185.5**	**-430.5**	**-138.9**	**67.7**	**-2.6**
2004–05	1041.3	20.6	**39.9**	**-85.1**	**-24.6**	**71.1**	**-2.4**
2005–06	1087.5	21.5	**40.5**	**-101.4**	**-39.4**	**61.2**	**-3.6**
2006–07	1024.5	20.2	**36.5**	**-102.1**	**-45.4**	**55.6**	**-4.4**
2007–08	987.7	19.5	**34.6**	**-95.7**	**-41.6**	**56.5**	**-4.2**
2008–09	**918.4**	**18.1**	**29.5**	**-93.2**	**-45.6**	**51.1**	**-5.0**
Total (2004–09)	**5059.3**	**99.9**	**181.0**	**-477.4**	**-196.4**	**58.9**	**-3.9**

Note: Highlighted figures are estimates.

[1] % Cost Recovery: revenues (registration and administration fees) divided by expenses (claims).

Table D-2 provides the same summary of the revenues and expense streams associated with each of the CSBF annual cohorts. This table takes into consideration the three- to five-year lag between when the revenues are received and when the expenses are paid (i.e., presented on a net present value [NPV] basis).

In aggregate, on an NPV basis:

- Revenues (registration and administration fees) for the five years of CSBF loans are expected to reach approximately $254 million.
- Expenses (claims) are expected to be approximately $404 million for a net cost of $150 million over the term of the loans.
- On a percentage basis, revenues are expected to offset expenses by 62.8 percent.
- From an overall loans portfolio perspective, the net cost to government is expected to be approximately 3 percent of loans made, up from 1.8 percent for loans made during the C1 (1999–2004) period.

Table D-2

Cost Recovery Model Summary: CSBF Program Period C1 (1999–2004) and Period C2 (2004–09) (NPV[1] Basis)

($ Millions)		NPV Revenues and Expenses				% Cost Recovery[2]	Net Cost/ Loans (%)
Cohort	Loans	Reg Fees	Admin Fees	Claims	Net Cost		
1999–2000	1352.3	26.1	**42.0**	**-99.1**	**-31.0**	**68.7**	**-2.3**
2000–01	1159.0	22.4	**36.6**	**-84.3**	**-25.3**	**70.0**	**-2.2**
2001–02	899.2	17.4	**27.7**	**-55.1**	**-10.1**	**81.7**	**-1.1**
2002–03	951.2	18.3	**27.7**	**-54.7**	**-8.6**	**84.3**	**-0.9**
2003–04	999.9	19.3	**27.2**	**-66.0**	**-19.5**	**70.5**	**-2.0**
Total (1999–2004)	5361.6	103.4	**161.3**	**-359.1**	**-94.4**	**73.7**	**-1.8**
2004–05	1041.3	20.1	**34.6**	**-71.2**	**-16.5**	**76.9**	**-1.6**
2005–06	1087.5	20.9	**35.2**	**-85.9**	**-29.7**	**65.4**	**-2.7**
2006–07	1024.5	19.7	**31.7**	**-86.8**	**-35.4**	**59.2**	**-3.5**
2007–08	987.7	19.0	**30.0**	**-81.2**	**-32.2**	**60.3**	**-3.3**
2008–09	**918.4**	**16.9**	**25.4**	**-78.9**	**-36.6**	**53.6**	**-4.0**
Total (2004–09)	**5059.3**	**96.6**	**157.0**	**-404.0**	**-150.4**	**62.8**	**-3.0**

Note: Highlighted figures are estimates.

1 Net present value (discount rate = 5%).

2 % Cost Recovery: NPV revenues (registration and administration fees) divided by NPV expenses (claims).

Conclusion

A comparison of the results for the first two lending periods of the CSBF Program indicates that cost recovery during 2004–09 has declined. Lower levels of cost recovery during this period can be partially attributed to higher levels of incremental lending through the program as well as slightly higher risk lending among a few of the major financial institutions. Industry Canada will continue to update its forecasts and refine its forecasting models on the basis of the latest available data, to ensure appropriate monitoring of this program objective.