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AN ANALYSIS OF THE TERM LOAN MARKET [v.9]

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AN ANALYSIS OF THE TERM LOAN MARKET

In 1980, for the fifth year in succession, funds raised by the non-financial business sector increased as a proportion of Gross National Expenditure[1]. Table 1 provides a summary of the major sources of funds raised by non-financial business excluding agriculture. Several major trends are brought out by the data in this table. First, it can be seen that equity issues exhibit a declining share of total new funding, as non-financial business continues the trend towards funding via a debt instrument rather than equity. The main beneficiaries of this trend have been the chartered banks whose share of total new funds provided to business rose from 34% ($4116 M) in 1977 to 49% ($12,752 M) in 1980. This represents an increase of $8,636 M or more than 210% in new business acquired. Allowing for the effect of inflation over this period, real growth in the chartered banks average outstanding loans exceeds 100%.

Another major group of beneficiaries is the affiliates of the foreign banks operating in Canada. This group of financial institutions saw their share of net new business grow from $574 million in 1977 to $2,762 million in 1980, a growth rate of 127% per year. Even though these institutions started from a relatively low base (and hence annual growth figures should not be directly compared with those of other institutions) they have managed to capture 17% of the growth in loans outstanding in 1980.

1. Bank of Canada Review, April 1981, p. 13.

Table 1

MAJOR SOURCES OF FUNDS RAISED BY PRIVATE NON-FINANCIAL BUSINESS*

1977-1980

	Millions of dollars			
	1977	1978	1979	1980
NET NEW ISSUES				
Bonds(1)				
Canadian dollar(2)	2,310	2,154	518	1,573
Foreign currency	1,298	1,021	771	1,271
Stocks				
Common	469	608	2,384	1,607
Preferred(3)	2,314	5,266	943	1,911
Commercial paper	-120	-225	176	279
Banker's acceptances	31	498	2,171	2,430
TOTAL NEW ISSUES	6,302	9,322	6,063	9,071
INCREASE IN LOANS				
Chartered banks(4)	4,116	3,618	12,032	12,752
Sales finance companies	725	419	1,004	550
Affiliates of foreign banks	574	813	1,112	2,762
Federal Business Development Bank	86	105	366	143
TOTAL INCREASE IN LOANS	5,501	4,955	14,514	16,207
DIRECT INVESTMENT FROM ABROAD	475	85	675	535
TOTAL FUNDS RAISED	12,278	14,362	21,252	25,813

* Excludes agriculture

(1) Canadian dollar issues placed abroad are included with foreign currency bonds and foreign currency issues placed in Canada are included with Canadian dollar bonds.
(2) Includes income debenture bonds.
(3) Includes term preferred shares.
(4) Total business loans excluding provincially guaranteed loans to utilities, plus foreign currency loans to residents.

Source: Bank of Canada Review, April 1981, p. 13

CHARTERED BANK BUSINESS LENDING

a) Total business loans

By the end of 1980, total loans of chartered banks to businesses exceeded $55 billion, making them the single largest source of external financing for businesses. Table 2 shows how this lending breaks down by level of authorization. As can be seen, the proportion of chartered bank lending made under authorizations above $5 million rose from 38% in 1973 to 45% in 1980. As shown in the study on Capital Markets by D.J. McFetridge, much of this increase can be traced to the impact of inflation pushing loans into higher nominal categories. However, the rise is reflected in an increase in the proportion of financial assets on the balance sheets of large corporations in Canada. The wave of mergers and acquisitions among large Canadian corporations during 1979 and 1980 has resulted in substantial additions of equity investments to corporate assets. Since market values are usually higher than book values due to inflation, these assets are put on the books of the acquiring corporations at current prices. Much of this acquisition activity has been financed by borrowing from the chartered banks, so that the liability side of the balance sheets of larger corporations have also shown corresponding increases. While such activity does represent net new business for the chartered banks, it does not necessarily imply a corresponding growth in the level of economic activity.

Table 2

TOTAL BUSINESS LOANS BY CHARTERED BANKS

Average Outstandings (in $ million)

Under authorization of

	Below $200K	$200K - $1,000K	$1,000K- $5,000K	-Above $5,000K	Total
1974	4043	3431	4204	7175	18853
1975	4658	3935	4845	8461	21899
1976	5595	4716	5544	9869	25724
1977	6748	5778	6363	10884	29773
1978	7650	6671	7219	11343	32883
1979	8480	7690	8871	14613	39654
1980	9602	8665	10601	21260	50128
			Percent		
1974	21.4	18.2	22.3	38.1	100.0
1975	21.3	18.0	22.1	38.6	100.0
1976	21.8	18.3	21.5	38.4	100.0
1977	22.7	19.4	21.4	36.5	100.0
1978	23.3	20.3	22.0	34.4	100.0
1979	21.4	19.4	22.3	36.9	100.0
1980	19.2	17.3	21.1	42.4	100.0

K = 000

Source: Bank of Canada Review, various issues.

b) Term loans

Turning to that proportion of chartered bank lending that is made under term loans, we see a somewhat different pattern. Table 3 shows average outstandings for term loans under authorizations above $200,000. Data for term loans by chartered banks under authorizations below $200,000 are not available. It can be seen that, for term loans, the average outstandings were close to $14 billion in 1980, of which some 57% was made under authorizations above $5 million. This proportion has not changed since 1974. On the other hand the proportion of term loans under authorizations between $200,000 and $1 million has increased from 17.5% in 1974 to 23.2% in 1980. This is the fastest growing category of term loans for the chartered banks. The growth in this category has come partly from conversion of some operating loans to term loans. Finally, the proportion of term lending under authorizations between $1 million and $5 million has declined from 26% in 1974 to 20% in 1980. This segment of the term lending market has become increasingly competitive in the period under review. Some factors leading to this situation are: the increasing activity of foreign bank affiliates, who have concentrated a substantial proportion of their activities in this market segment; the growth of a specialized term lender - RoyNat - which is active in this market sector; increasing interest of non-bank financial institutions in making term loans to businesses.

Some portion of the changes described above are the result of the inflation effect described earlier. The reader is referred to the McFetridge paper on Capital Markets for a detailed treatment.

Table 3

CHARTERED BANK TERM LOANS TO BUSINESS

Average Outstandings (in $ Million)

Under authorizations of

	$200K-$1,000K	$1,000K-$5,000K	Above $5,000K	Total of all loans above $200K
1974	789	1160	2565	4514
1975	942	1345	3070	5357
1976	1266	1627	3736	6629
1977	1685	1855	4278	7818
1978	2259	2074	4447	8780
1979	2857	2415	5815	11087
1980	3244	2798	7947	13989
		Percent		
1974	17.5	25.7	56.8	100.0
1975	17.5	25.2	57.8	100.0
1976	19.1	24.5	56.3	100.0
1977	21.6	23.7	54.7	100.0
1978	25.7	23.6	50.7	100.0
1979	25.7	21.8	52.5	100.0
1980	23.2	20.0	56.8	100.0

Source: Special tabulations provided by Bank of Canada staff.

In order to study the growth in term lending, we have to separate the effects of inflation from total growth. This is done in Table 4 which shows growth in total term lending under authorizations above $200,000. The first column shows the implicit GNE deflator derived from the index of price escalation in Gross National Expenditure (Statistics Canada data). Total growth in average outstanding loans is calculated by taking the difference between average outstandings in consecutive years. From this we then subtract the inflation effect which is calculated by applying the GNE deflator to the average outstanding of the previous year. The result is an estimate of real growth (expressed in previous year dollars), which is the shown as a percentage of the previous year's average outstanding. These figures are slight over-estimates of real growth because inflation also causes some loans which are in the below $200,000 category in real terms to appear in the next higher category in nominal terms. As can be seen, there was strong real growth in outstandings throughout the period. The rate of growth, however,was volatile, with low figures during periods of relatively slow overall economic growth, and higher growth during boom periods.

Table 4

CHARTERED BANK TERM LOANS UNDER AUTHORIZATIONS OVER $200,000

Growth in Average Outstandings in $ Million

	Implicit GNE Deflator	Total Growth	Inflation Effect	Real Growth	% Increase
1974 to 75	10.8	843	488	355	7.9
1975 to 76	9.5	1272	509	763	14.2
1976 to 77	7.0	1189	464	725	10.9
1977 to 78	6.3	962	493	469	6.0
1978 to 79	10.3	2307	904	1403	16.0
1979 to 80	10.6	2902	1175	1727	15.6

When these overall growth figures are disaggregated to the different authorization limit categories, some interesting patterns emerge. Table 5 shows the growth in term loans with authorizations between $200,000 and $1 million. This category grew vigorously between 1975 and 1979 with an average annual rate exceeding 20%. This period would seem to mark a change in chartered bank policies towards term lending to this class of business. This resulted in a substantial increase in the share of chartered banks in this segment of the market. However, this growth pattern changed abruptly in the 1979-80 period when real growth slowed to less than 3.0% -- just above the rate of real growth in the economy at large.

Table 5

YEAR-TO-YEAR GROWTH IN CHARTERED BANK TERM LOANS OUTSTANDING UNDER AUTHORIZATIONS $200,000 TO $1 M

Growth in Average Outstandings in $ Million

	Implicit GNE Deflator	Total Growth	Inflation Effect	Real Growth	% Increase
1974 to 75	10.8	153	85	68	8.6
1975 to 76	9.5	324	89	235	24.9
1976 to 77	7.0	419	89	330	26.1
1977 to 78	6.3	574	106	468	27.8
1978 to 79	10.3	598	233	365	16.2
1979 to 80	10.6	387	303	84	2.9

Throughout this period, the ratio of term loans to total business loans has been growing steadily for authorizations between $200,000 and $1 M. This is shown in Table 6. In 1974, almost one-quarter of loans under these limits were term loans. This proportion has now grown to in excess of one-third. It appears likely that growth in this ratio will slow somewhat, and that therefore we will not see as high a growth rate for term loans in this category as we have in the past.

Table 6

CHARTERED BANKS: BUSINESS AND TERM LOANS BETWEEN $200,000 AND $1 M

Average Outstanding in $ Million

	Business Loans	Term Loans	Term as % of business
1974	3431	789	23.0
1975	3935	942	23.9
1976	4716	1266	26.8
1977	5778	1685	29.2
1978	6671	2259	33.9
1979	7690	2857	37.2
1980	8665	3244	37.4

Turning to term loans under authorizations between $1 M and $5 M, we can see from Table 7 that growth in this category has been steady but unspectacular. In only one year - 1976 - did growth exceed 10%. For most of the period, growth was closer to 5%, which is still higher than overall real national economic growth, indicating that it is likely that chartered banks steadily increased their market share in this category of lending throughout the period.

Table 7

YEAR-TO-YEAR GROWTH IN CHARTERED BANK TERM LOANS OUTSTANDING UNDER AUTHORIZATIONS $1 M - $5 M

Growth in Average Outstanding in $ Million

	Implicit GNE Deflator	Total Growth	Inflation Effect	Real Growth	% Increase
1974 to 75	10.8	185	125	60	5.2
1975 to 76	9.5	282	128	154	11.4
1976 to 77	7.0	228	114	114	7.0
1977 to 78	6.3	219	117	102	5.5
1978 to 79	10.3	341	214	127	6.1
1979 to 80	10.6	383	256	127	5.3

On the other hand, the growth pattern in the average outstandings for term loans under authorizations above $5 M has been extremely volatile, as shown in Table 8. While in one year (1977) real growth was actually negative, in other years real growth exceeded 20%. It is likely that a large proportion of growth between 1978 and 1980 can be accounted for by term loans to finance acquisitions of financial assets - i.e. shares of other corporations. The rapid growth in outstandings in this segment made up for the decline in growth rates for loans under authorizations between $200,000 and $1 M.

Table 8

YEAR-TO-YEAR GROWTH IN CHARTERED BANK TERM LOANS OUTSTANDING UNDER AUTHORIZATIONS ABOVE $5 M

Growth in Average Outstanding in $ Million

	Implicit GNE Deflator	Total Growth	Inflation Effect	Real Growth	% Increase
1974 to 75	10.8	505	277	228	8.9
1975 to 76	9.5	666	292	374	12.2
1976 to 77	7.0	542	262	280	7.5
1977 to 78	6.3	169	270	-101	(2.4)
1978 to 79	10.3	1368	458	910	20.5
1979 to 80	10.6	2132	616	1516	26.1

It is interesting to compare the growth rates in Table 8 with the growth in total lending by the chartered banks under authorizations above $5 M. The latter are shown in Table 9. As can be seen, the same patterns of extreme volatility can be observed in this set of figures - in fact, the growth in total outstandings in the 1979-80 period was nearly 35%, indicating that operating loan growth far exceeded term loan growth. It is likely that growth in term loans will continue to be high in 1981 and perhaps 1982 as some proportion of these operating loans are converted to term loans.

Table 9

YEAR-TO-YEAR GROWTH IN CHARTERED BANK TOTAL BUSINESS LOANS UNDER AUTHORIZATIONS ABOVE $5 M

Growth in Average Outstanding in $ Million

	Implicit GNE Deflator	Total Growth	Inflation Effect	Real Growth	% Increase
1974 to 75	10.8	1286	775	511	7.1
1975 to 76	9.5	1408	804	604	7.1
1976 to 77	7.0	1015	691	324	3.3
1977 to 78	6.3	459	686	-227	(2.1)
1978 to 79	10.3	3270	1168	2102	18.5
1979 to 80	10.6	6647	1549	5098	34.9

Finally, while data are not available on chartered bank term loans under authorizations below $200,000, it is possible to estimate them using certain assumptions. Table 10 shows an estimate of term loans in this segment using the assumption that 30% of the loans are term loans - about the average level for the next higher category. This table shows that term loans to this segment have reached nearly $2.9 billion. It is not possible to estimate the growth rate of these loans in the same manner as we did for other categories. An indirect estimate of this growth can be made by looking at the rate of growth of total chartered bank loans under authorizations below $200,000. This is shown in Table 11. It is likely that real growth in term loans in this subsector was slightly lower than the 4.4% shown for total loans in 1974-75 and slightly higher than the 2.6% shown for 1979-80 if the trend towards converting operating to term loans for the next higher authorization category applies here as well. In addition, because inflation pushes some loans into the above $200,000 categories each year, the growth figures shown in Table 10 underestimate real growth.

Table 10

CHARTERED BANK LOANS TO BUSINESS
UNDER AUTHORIZATIONS BELOW $200,000

	Total business loans outstanding (year-end outstanding)	Of which term is 30%	Average Outstanding Term (Estimates)
1974	4379	1314	--
1975	4936	1481	1398
1976	6253	1876	1679
1977	7243	2173	2025
1978	8056	2417	2295
1979	8904	2671	2544
1980	10299	3090	2881

Note: Includes SBLA

Source: Bank of Canada Review: Table 10, series B1415

Table 11

YEAR-TO-YEAR GROWTH IN CHARTERED BANK
TOTAL BUSINESS LOANS UNDER AUTHORIZATIONS
BELOW $200,000

Growth in Average Outstanding in $ Million

	Implicit GNE Deflator	Total Growth	Inflation Effect	Real Growth	% Increase
1974 to 75	10.8	615	437	178	4.4
1975 to 76	9.5	937	443	494	10.6
1976 to 77	7.0	1153	392	761	13.6
1977 to 78	6.3	902	425	477	7.1
1978 to 79	10.3	830	788	42	0.5
1979 to 80	10.6	1122	899	223	2.6

The regional distribution of chartered bank lending to business is shown in Table 12. Separate data are not available for term loans, but it is expected that by and large they should follow similar patterns. It will be noticed that while total lending is roughly in proportion to each province's share of GNE, the size distribution of lending varies quite considerably. Thus, in Alberta the proportion of loans under authorizations above $5.0 million is much higher than the national average. This probably reflects the concentration of large energy projects in that province. Conversely, in the Altantic provinces, the proportion of outstandings under authorizations below $200,000 is higher than the national average, reflecting the proportionately greater role that smaller business plays in the economies of those provinces.

Table 12

REGIONAL DISTRIBUTION OF CHARTERED BANK
TOTAL LOANS TO BUSINESS

Average Outstanding - 1980 in $ million

	Above $5,000K	$1,000K to $5,000K	$ 1,000K- $ 200K	Below $ 200K	Total
Newfoundland	175 (1)	141 (2)	112 (3)	139 (4)	567
P.E.I.	25	32	36	48	141
Nova Scotia	305	218	228	245	996
New Brunswick	291	184	152	179	806
Quebec	3174	2275	1769	1887	9105
Ontario	8251	4235	3183	3164	18833
Manitoba	644	398	358	355	1755
Saskatchewan	153	196	226	318	893
Alberta	6189	1886	1292	1130	10497
B.C.	2273	1337	1396	1796	6802
Yukon & N.W.T.	2	12	32	37	83
Head Office and/or International	516	146	70	59	791
Total	21998	11060	8854	9357	51269

Source: Bank of Canada Review

1. Table 12, Series B4937/49
2. " " " B4924/36
3. " " " B4911/23
4. " " " B4898/4910

FOREIGN BANK AFFILIATES

It is reported that there are some 98 affiliates of foreign banks operating in Canada. Of these, 47 have been granted bank status under the 1980 revision to the Bank Act. Undoubtedly, some others will also apply, so that by the end of 1982, there could be as many as 60 foreign banks doing business in Canada. The entry and recent rapid growth of market shares of these financial institutions has been a major force for change in the term loan market in Canada.

Foreign bank affiliates deal almost exclusively with business clients. Up to now, they have concentrated their efforts on non-financial businesses, though they have provided funds to financial businesses as well. Their clientele tends to be drawn from Canadian small and medium businesses (mainly the larger firms in these categories), Canadian subsidiaries of foreign parent firms and to a lesser extent the large scale Canadian firms and their subsidiaries.

Driven by a perception that it was important to develop a substantial portfolio of assets before the Bank Act was revised, these foreign bank affiliates aggressively sought loan business from this pool of potential clients. In this battle to increase market share, a major weapon has been the use of highly competitive interest rates. These institutions have, in general, gone after low risk, established businesses with a track record for growth. Frequently, a particular institution has specialized in a particular type of asset or a particular industry. This enables them to use formula lending approaches that minimize transaction costs. Frequently, too, the approaches used have been adopted or developed from products used by the parent institution, thus taking advantage of learning curve effects in keeping operating costs under control. Another operating cost advantage arises from the fact that these institutions operate with a minimum of branches -- many have only a single office in Canada. Finally, until the 1980 Bank Act, these financial institutions were not subject to reserve requirements similar to those under which Canadian chartered banks operate; hence their net cost of funds was slightly lower. Despite operating cost advantages, and a loss rate substantially below other lenders (due to their concentration on low risk clients), the intensity of price competition necessary to increase market share has prevented these institutions from showing substantial profits from their Canadian operations. Indeed, most observers tend to agree that the foreign bank affiliates have operated at break even or less during the last four years in order to establish themselves in this market.

The results of this strategy can be seen clearly in Table 13. Average assets outstanding has grown from $2,126 million in 1977 to $5,834 in 1980. The bulk of this growth has come from loans to business, about evenly divided between operating and term loans. It appears that once these institutions succeed in financing one type of asset for a client, they also tend to finance other assets. Clearly, there are scale economies associated with this practice, since some of the costs associated with getting to know the client's business are fixed. Thus, it is to be expected that growth of operating and term loans will proceed in parallel.

Table 13

FOREIGN BANK AFFILIATES

Average assets outstanding in $ million

			Business Loans		
	Leasing (1)	Real Estate (2)	Less than 1 year term (3)	More than 1 year (4)	Total
1977	364	507	634	620	2126
1978	384	386	1091	822	2683
1979	479	440	1557	1156	3632
1980	592	589	2554	2099	5834

Source: Bank of Canada Review
1. Table 47, Col. 4
2. " " " 5
3. " " " 6
4. " " " 7

It has been estimated by McFetridge that about 30% of the term loans made by these institutions are under authorizations of between $200,000 to $5 million. Applying this assumption to the data in Table 14, we can estimate their growth in this market as follows:

Table 14

YEAR-TO-YEAR GROWTH IN FOREIGN BANK AFFILIATES' TERM LOANS UNDER AUTHORIZATIONS BETWEEN $200,000 AND $5 MILLION

Growth in Average Assets Outstanding in $ Million

	Implicit GNE deflator	Average term loan outstanding	Average outstanding $200,000-$5 M	Year-to-Year Increase	Inflation effect	Real Growth	% Increase
1977	7.0	620	186	-	-	-	-
1978	6.3	822	247	61	12	49	26.3
1979	10.3	1156	347	100	25	75	30.4
1980	10.6	2099	630	283	37	246	70.9

Source: See Table 13 and text.

Almost all the $630 million of smaller term loans has been made to low risk clients at very competitive interest rates. During this same period, the chartered banks were also increasing their penetration of this market segment. Similarly, institutions such as RoyNat and some of the other non-bank financial institutions were attempting to increase their assets in this sector. The resultant competition had an impact on interest rates; in particular, the differences between interest rates offered to clients in this sector and larger clients declined throughout the period.

Now that the revisions to the Bank Act have been made, it is likely that the rate of growth of assets of foreign bank affiliates will decline somewhat for several reasons. Firstly, the reserve requirements imposed on the newly registered banks will raise their cost of funds by some 50 basis points at current interest rate levels. Up to now, the foreign bank affiliates have operated without such reserves, and thus had a competitive edge over the Canadian chartered banks. Secondly, it is unlikely that the majority of these institutions will be content to operate at break even or worse for an extended period of time. In order to provide for the cost of reserves and operate at interest rates that allow some profits, they will be forced to increase their rates by 50 to 100 basis points. However, this by no means implies that they will allow their market shares to slip. On the contrary, it is to be expected that they will continue to pursue low risk clients in this sector with a formula lending, low interest rate approach. The upper limit to their growth is the ceiling that the Bank Act imposes on the share of Canadian dollar assets these institutions are allowed to hold. Their Canadian assets cannot exceed 8% of the Canadian assets of the Canadian chartered banks, a ceiling they are expected to reach by mid-1983. After this occurs, the growth of their assets will be limited by the growth rate of the Canadian chartered banks.

NON-BANK FINANCIAL INSTITUTIONS

Recent years have witnessed increasing interest in the term loan market on the part of non-bank financial institutions such as trust companies, credit unions, financial corporations and other lenders who have traditionally not been a major factor in lending to business. While the total activity of these institutions does not approach anything like the volume of the lending done by the chartered banks, nevertheless their attempts to increase their share of this market have led to greater competition and more favourable interest rates and lending conditions from a borrower's viewpoint.

A major set of reasons frequently cited for the increasing interest of these lenders in business loans is the developments that have occurred in the residential mortgage market that has been a major source of business for these institutions . Table 15 below shows the new mortgages approved each year for both new and existing residential property, while Table 16 examines the growth in total new mortgage approvals adjusted for inflation. As can be seen, real growth in mortgage approvals has been negative since 1977. This decline in the size of the mortgage market has seriously affected the ability of some non-bank financial institutions to place their funds in their traditional markets.

Table 15

MORTGAGE LOANS APPROVED

(Residential only)
$ million

	New Construction (1)	Existing Houses (2)	Total
1970	$2287	$ 755	$ 3042
1971	3141	1400	4541
1972	3472	1927	5399
1973	4135	3313	7448
1974	3514	3309	6823
1975	5842	4368	10210
1976	6358	4494	10852
1977	6947	8020	14967
1978	5671	8507	14178
1979	5548	8479	14027

Source: Bank of Canada Review:
1. Table 61, col. 6
2. Table 61, col. 11

Table 16

YEAR-TO-YEAR GROWTH IN MORTGAGE LOANS APPROVAL

	Implicit GNE Deflator	Total Growth	Inflation Effect	Real Growth	% Increase
1970 to 71	3.1	1499	94	1405	46.2
1971 to 72	5.0	858	227	631	13.9
1972 to 73	9.1	2049	491	1558	28.8
1973 to 74	15.3	(625)	1139	-1764	(23.7)
1974 to 75	10.8	3387	737	2650	38.8
1975 to 76	9.5	642	970	- 328	(3.2)
1976 to 77	7.0	4115	760	3355	30.9
1977 to 78	6.3	(789)	943	-1732	(11.6)
1978 to 79	10.3	(151)	1460	-1611	(11.4)

At the same time, the mortgage market has witnessed substantial activity on the part of the chartered banks who have increased their average mortgage assets outstanding through the period under study. This is shown below in Tables 17 and 18. Table 17 shows that mortgages held by the chartered banks and their specialized mortgage subsidiaries increased from $1.5 billion in 1970 to over $26.4 billion in 1980, an increase of 1660 percent. By 1980, the chartered banks had gained an important share of the residential mortgage market. The rate of growth, corrected for inflation effects, is shown in Table 18. It can be seen that real growth of the mortgages assets of the chartered banks has been substantial for this period.

Table 17

MORTGAGES HELD BY CHARTERED BANKS
AND THEIR SUBSIDIARIES

Year-end Assets Outstanding in $ million

	Mortgages held by Chartered Banks: Insured under NHA (1)	Mortgages held by Chartered Banks: Other Residential (2)	Mortgages held by subsidiaries (3)	Total
1970	1100	357	n/a	1457
1971	1681	627	n/a	2308
1972	2436	958	n/a	3394
1973	2890	1674	1163	5727
1974	3316	2707	1384	7407
1975	4178	3522	1804	9504
1976	5218	3865	2424	11507
1977	7059	4687	3258	15004
1978	9005	6157	3642	18804
1979	10156	7902	5069	23127
1980	9632	8867	7922	26421

Source: Bank of Canada Review
1. Table 7, Series B620
2. Table 7, Series B621
3. Table 42

The long term effects of a real decline in the mortgage market and the substantial increase in the market share of the chartered banks have resulted in serious problems for some non-bank financial institutions. If these trends continue into the future, it is reasonable to expect that institutions which have depended heavily on the residential mortgage market will look elsewhere for acquisition of financial assets. One such avenue of activity is the business loan market.

Table 18

YEAR-TO-YEAR GROWTH IN MORTGAGE LOANS BY CHARTERED BANKS

Growth in Average Outstandings in $ Million

	Implicit GNE Deflator	Total Growth	Inflation Effect	Real Growth	% Increase
1970 to 71	3.1	492	43	449	32.3
1971 to 72	5.0	968	94	874	46.4
1972 to 73	9.1	1709	259	1450	50.9
1973 to 74	15.3	2007	698	1309	28.7
1974 to 75	10.8	1889	709	1180	18.0
1975 to 76	9.5	2050	803	1247	14.8
1976 to 77	7.0	2749	735	2014	19.2
1977 to 78	6.3	3649	835	2814	21.2
1978 to 79	10.3	4062	1741	2321	13.7
1979 to 80	10.6	3808	2222	1586	7.6

Credit Unions

While credit unions have not traditionally been active in lending to non-agricultural business, in recent years their activity in this area has grown substantially. Average business loans outstanding has increased from $85 million in 1974 to a little over $671 million in 1980. Table 19 below shows the business loans of local and central credit unions. Data on lending by provincial centrals are not available, but are expected to be about 10% of the figures shown for the locals. The data in Table 19 includes figures for the Caisses populaires and the Desjardins group in Quebec. Since the lending activities of the latter are largely to business firms, it is assumed that a significant proportion of credit union loans to business are in the province of Quebec.

Table 19

CREDIT UNIONS(1)

Loans to Businesses in $ million

	Year-end Outstanding	Average Outstanding
1973	41	-
1974	128	85
1975	216	172
1976	268	242
1977	309	288
1978	338	324
1979	582	460
1980	761	671

(1)Includes Caisses populaires in Quebec

Source: Statistics Canada, Financial Institutions, 61-006 Tables 21 and 28

Table 20 below examines the rate of growth, adjusted for inflation effects. As can be seen, even with inflation removed, the growth in business loans of the credit unions has been substantial, with the exception of two years when growth, though positive, was not in line with the experience of other years. With a $671 million business loan portfolio in 1980, the credit unions have become a significant, though nevertheless small, force in the term loan market.

Table 20

GROWTH IN LOANS TO BUSINESS BY CREDIT UNIONS

Growth in Average Outstanding in $ million

	Implicit GNE Deflator	Total Growth	Inflation Effect	Real Growth	% Increase
1974 to 75	10.8	87	9	78	91.8
1975 to 76	9.5	70	16	54	31.4
1976 to 77	7.0	46	17	29	10.1
1977 to 78	6.3	36	18	18	5.6
1978 to 79	10.3	136	33	103	31.8
1979 to 80	10.6	211	49	162	35.2

Sales Finance Companies

This group of companies includes the financing subsidiaries of the automobile manufacturers and farm equipment manufacturers as well as companies that specialize in the financing of commonly used equipment. These companies have traditionally been active in providing funds to business, mainly through their purchase of commercial paper from equipment and vehicle dealers. In addition, they have also been active in consumer financing of vehicles and durables. In Table 23 we show the financing of commercial and industrial goods by these companies. Average outstandings have grown from $1.829 billion in 1974 to $3.712 billion in 1980. About 53% of this financing related to commercial vehicles in 1971, rising to slightly less than 60% in 1980. The bulk of the financing is of an installment payment or term nature.

Table 23

SALES FINANCE AND CONSUMER LOAN COMPANIES

Financing of Commercial and Industrial Goods
in $ million

	Year-end Outstanding	Average Outstanding
1973	1657	-
1974	2000	1829
1975	2248	2124
1976	2461	2355
1977	2727	2594
1978	3028	2878
1979	3384	3206
1980	4040	3712

As can be seen from Table 24 below, the growth in the business financing activities by this group of companies has been modest at best. Particularly in recent years, average growth has barely kept up with the general rate of real growth in the economy.

Table 24

YEAR-TO-GROWTH IN SALES FINANCE AND
CONSUMER LOANS COMPANIES

Financing of Commercial & Industrial Goods

	Implicit GNE Deflator	Total Growth	Inflation Effect	Real Growth	% Increase
1974 to 75	10.8	295	198	97	5.3
1975 to 76	9.5	231	202	29	1.4
1976 to 77	7.0	239	165	74	3.1
1977 to 78	6.3	284	163	121	4.5
1978 to 79	10.3	328	296	32	1.1
1979 to 80	10.6	506	340	166	5.8

Trust Companies

The trust companies are limited by law in terms of the nature of their lending to business, particularly with regard to the level and type of collateral they can accept. Therefore, they have not traditionally been very active in lending to business. Some loans to business have been made within the "basket clause" of the Trust Companies Act, whereas others have been made against required collateral. Table 26 shows the average business loans outstanding for the trust companies as a group. These figures include only loans made by the trust companies themselves, and excludes loans made by financial subsidiaries of the trust companies, such as financial corporations and sales finance companies. It can be seen that the average outstanding business loans of the trust companies has increased from $176 million in 1975 to $427 million in 1980. Table 27 shows this growth in year to year terms. Business loans have formed only a small part of the asset portfolio of the trust companies, and it would appear that their importance has increased only slowly during recent years. Interviews with senior executives of these companies have revealed that this may be attributed to a shift in the business lending activity from the trust companies to their financial subsidiaries.

Table 26

TRUST COMPANIES

Collateral Loans to Business in $ million

	Year-end Outstanding (1)	Average Outstanding
1974	176	-
1975	175	176
1976	252	214
1977	290	271
1978	357	324
1979	382	370
1980	471	427

Source: Bank Of Canada Review
1. Table 40, p. 588

Table 27

MORTGAGE AND TRUST COMPANIES' BUSINESS LOANS

Growth In Average Outstanding in $ Million

	Implicit GNE Deflator	Total Growth	Inflation Effect	Real Growth	% Increase
1975 to 76	9.5	38	16	22	12.5
1976 to 77	7.0	57	15	42	19.6
1977 to 78	6.3	53	17	36	13.3
1978 to 79	10.3	46	33	13	4.0
1979 to 80	10.6	57	39	18	4.9

Other Financial Institutions

Some other financial institutions have begun to display an interest in lending to businesses. Pension funds and life insurance companies, for instance have been placing a small proportion of their new funds into term loans to business.

However, the most significant institution in this category is RoyNat, which describes itself as being "in the business of providing term financing and equipment leasing to Canadian businesses".(1) By the end of 1980, RoyNat's loans to businesses in Canada exceeded $800 million. This does not include leasing assets which account for an additional $50 million. The growth in RoyNat's total assets shown below in Table 28. The bulk of these assets consist of term loans under authorizations below $5 million. In 1979, the average amount of financing committed to a client was $282,000.

Table 28

RoyNats' Assets

	Total Assets
1975	$298
1976	408
1977	473
1978	548
1979	611
1980 est.	850

Note: Fiscal year data ending April 30
Source: RoyNat Annual Reports

SUBSIDIZED TERM LENDING

The Government of Canada assists small business in obtaining term financing through a number of programs. Up until 1980, the three major programs of the federal government were the direct lending activity of the Federal Business Development Bank, loans made under the Small Businesses Loans Act and loans made under the Enterprise Development Program. In November 1980, an additional program - the Small Business Development Bond - was approved.

The Federal Business Development Bank

The average annual loans outstanding of the Federal Business Development Bank grew from $451 million in 1970 to over $2 billion as shown in Table 29, below. When compared with the $55 billion of chartered bank loans outstanding to business, the market share of the FBDB does not appear to be large. However, it should be kept in mind that the loans made by the FBDB are of a term nature, and that the majority of these loans are made under the authorizations below $200,000. Therefore, the FBDB serves mainly a special segment of the market - small businesses in need of term financing. In Table 10 it was estimated that the average loans outstanding of the chartered banks in this category was approximately $2.9 billion in 1980. Therefore, it is

(1.) RoyNat, Annual Report, 1979, p. 12.

reasonable to conclude that the FBDB has the largest share of the market in this segment, and that the share of the chartered bank with the most loans in this category is likely to be less than half the share of the FBDB.

Table 29

FEDERAL BUSINESS DEVELOPMENT BANK

Year-end and Average Annual Loans Outstanding in $ million

	Year-end Outstanding	Average Outstanding
1969	486	-
1970	542	514
1971	610	576
1972	731	671
1973	984	858
1974	1171	1078
1975	1272	1222
1976	1415	1344
1977	1494	1455
1978	1646	1570
1979	2049	1848
1980	2062	2056

Source: Bank of Canada Review
Table 49, col. 5

Note: Fiscal year ending March 31 of the succeeding calendar year (i.e. fiscal year ended March 31, 1970 reported as 1969).

Growth rates of the FBDB's portfolio of loans has varied somewhat from a high of 15% per year in real terms (1974 to 1975) to a low of 3% per year (in 1976 to 1977). However, in general the growth of the FBDB portfolio has exceeded the real growth rate of the economy, as well as the growth of some other lenders to the subsector the bank serves. It is interesting to compare the growth of the FBDB with the growth in chartered bank lending under authorizations below $200,000.

Table 30

YEAR-TO-YEAR GROWTH IN FEDERAL BUSINESS DEVELOPMENT BANK LOANS

	Implicit GNE Deflator	Total Growth	Inflation Effect	Real Growth	% Increase
1970 to 71	3.1	62	16	46	9.0
1971 to 72	5.0	95	29	66	11.5
1972 to 73	9.1	187	61	126	18.8
1973 to 74	15.3	220	131	89	10.4
1974 to 75	10.8	144	116	28	2.6
1975 to 76	9.5	122	116	6	0.5
1976 to 77	7.0	111	94	17	1.3
1977 to 78	6.3	115	92	23	1.6
1978 to 79	10.3	278	162	116	7.4
1979 to 80	10.6	208	196	12	0.7

It appears from these figures that the growth of the loan portfolio of the FBDB (following rapid real growth in the early part of the decade) increased at a sharply lower rate in the latter half of the decade, with the exception of fiscal 1979/80. Furthermore, as Table 30 indicates, the loan portfolio of FBDB grew most rapidly in thesse years in which the portfolio of chartered bank lending under authorized limits of less than $200,000 was experiencing relatively modest growth. Conversely, in those periods when the growth in chartered bank lending to small business was high, the rate of growth in the FBDB loan portfolio was low. The evidence would seem to suggest that the markets served by the FBDB and the chartered banks might overlap to an extent.

Table 31

COMPARISON OF FBDB & CHARTERED BANK LENDING

Year-to-Year Real Growth in Average Annual Outstanding

	FBDB	Chartered Bank*
1974 to 75	2.6%	4.4%
1975 to 76	0.5	10.6
1976 to 77	1.3	13.6
1977 to 78	1.6	7.1
1978 to 79	7.4	0.6
1979 to 80	0.7	2.6

Note: * Total loans to business under authorizations below $200,000

Small Businesses Loans Act

Under this legislation, lenders are provided with a federal government guarantee on term loans below $100,000 made to eligible small businesses. In return, lenders are required to charge the borrowers a concessional interest rate prime plus 1 percent. In practice, the bulk of the loans under the SBLA program are made by the chartered banks. Table 32 below shows the history of chartered bank lending under this program. It will be noticed that the size of the program was relatively modest until 1975, after which it has grown rapidly. Average outstandings in 1980 exceed half a billion dollars. Considering that loans under this program have an upper limit of $100,000, it appears that the SBLA is not insignificant within the subsegment of the market it is designed to serve, even though it is certainly small in proportion to total term lending by the chartered banks.

Table 32

CHARTERED BANK LOANS OUTSTANDING UNDER SBLA

In $ million

	Year-end Outstanding	Average Outstanding
1970	64	-
1971	73	69
1972	82	78
1973	98	90
1974	117	108
1975	160	139
1976	211	186
1977	236	224
1978	319	278
1979	447	383
1980	661	554

Source: Bank of Canada Review
Table 10, series B1413

Table 33 examines the growth in average loans outstandings under the SBLA. The program can be seen to have grown rapidly between 1975 and 1980. In this period growth of SBLA loans has been relatively high compared to that of other institutions that serve the same market. It is interesting to note that the amount of real growth in loans outstanding under the SBLA ($130M) exceeded that of the FBDB ($12M) in 1980.

Table 33

CHARTERED BANK SBLA LOANS

Growth in Average Outstanding in $ Million

	Implicit GNE Deflator	Total Growth	Inflation Effect	Real Growth	% Increase
1971 to 72	5.0	9	3	6	8.7
1972 to 73	9.1	12	7	5	6.4
1973 to 74	15.3	18	14	4	4.4
1974 to 75	10.8	31	12	19	17.6
1975 to 76	9.5	47	13	34	24.5
1976 to 77	7.0	38	13	25	13.4
1977 to 78	6.3	54	14	40	17.9
1978 to 79	10.3	105	29	76	27.3
1979 to 80	10.6	171	41	130	33.9

The Small Business Development Bond

The Small Business Development Bond program was approved in late 1980 to run for a limited two year period. Under this program, interest costs on certain types of loans to qualifying small businesses are treated as non taxable income in the hands of the lender, while the borrower is not allowed to claim the interest as an expense. Lenders pass on some of the tax sheltering benefits to the borrower in the form of a lower interest rate - typically half prime plus 2 percent. Since the program has only recently been approved, there are as yet no official statistics on average outstandings. However, Department of Finance officials estimate that outstandings could have reached $2 billion by the end of December 1981. It is, however, too early to comment on the penetration and impact of the program.

Provincial Programs

Most provincial governments also operate programs to provide subsidized loans to businesses. Frequently, these programs are designed to be supplemental to both the private sector as well as the federal government's subsidized programs. It is not clear how well these distinctions are maintained in practice, nor to what extent the provincial programs are competitive with federal programs and the private sector. Further, there is no source of consistent statistics on these programs. A recent estimate of the loans made by provinces Under these programs shown in Table 34 below. This estimate was made by the staff of the Small Business Financing Review on the basis of information collected on each program.

Table 34

LOANS MADE BY PROVINCIAL PROGRAMS

$ million in latest fiscal year

	Loans made latest in fiscal year
British Columbia	$ 83
Alberta	191
Saskatchewan	29
Manitoba	3
Ontario	55
Quebec	62
New Brunswick	n/a
Nova Scotia	48
Prince Edward Island	18
Newfoundland/Labrador	7
Total	$496 million

Source: Small Business Financing Review paper on "Government Financial Assistance Programs Available to Small Business"

Given that most of the loans under these programs are of a term nature, it is estimated that the average outstandings in all the programs taken together will be about three times the annual disbursements. This ratio is somewhat lower than the historical ratio for the FBDB, but appears reasonable in light of the fact that the programs have grown most rapidly in recent years. Using this assumption would place the average outstanding of the provincial programs at $1,488 billion.

Total Subsidized Lending

Table 35 below provides an estimate of the total outstandings under the various subsidized lending programs listed above. Together these programs have an average outstanding in excess of $4.5 billion. The following section will attempt to put this figure into a total market perspective.

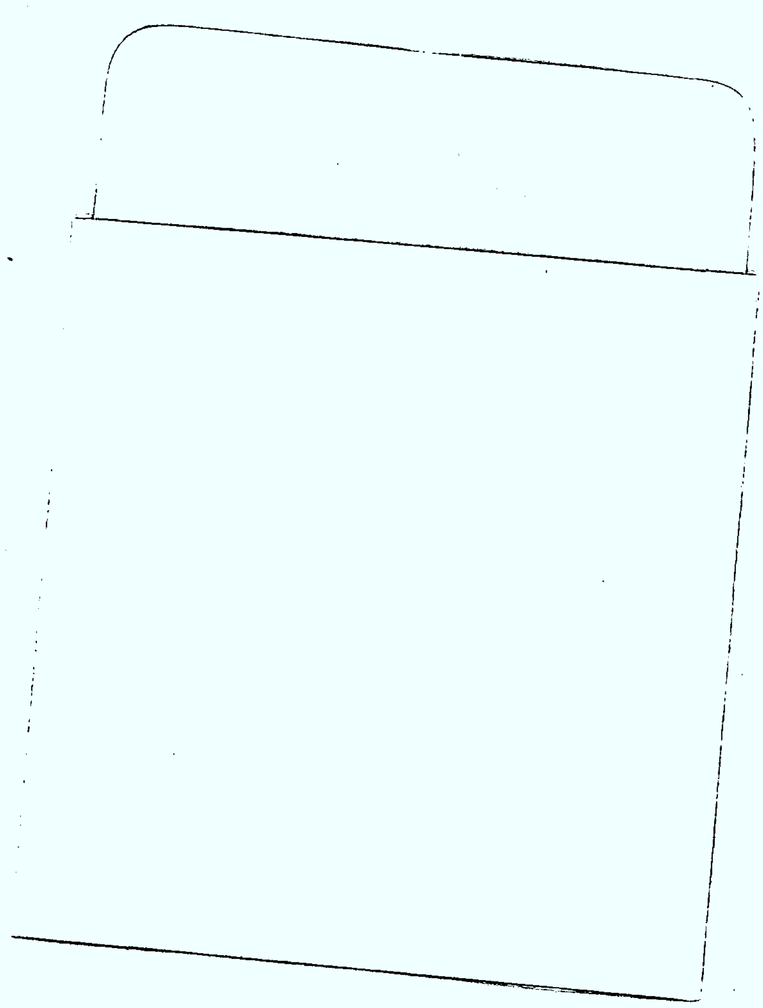
Table 35

ESTIMATED OUTSTANDINGS UNDER SUBSIDIZED TERM LENDING PROGRAM

$ million

	Estimated average outstanding in 1980
FBDB - actual	$2086
SBLA - actual	554
SBDB - estimate	500
Provincial - estimate	1448
EDP	139
Total	$4727

Source: See text and tables above.



Term Loans Under $5 million

The segment of the market covering terms loans under authorizations below $5 million is of special interest to the Small Business Financing Review because that is the area in which the government subsidized lending programs operate. Table 36 below provides an estimate of the size of this market and the market shares of the major financial institutions who participate in this market. The estimates for the chartered banks and foreign bank affiliates cover only term loans under authorizations below $5 million. Estimates for all other institutions include all their term loans because it is assumed that they seldom, if ever, make loans above $5 million. The total market for term loans under $5 million was estimated at $19 billion. On the whole, this market grew at an average of 12.0% per year in real terms during the last five years.

Table 36

TERM LOANS UNDER $5 MILLION

1980 Estimates

	Average Outstanding ($ million)	Market Share
Chartered Banks*	$8929	47.2%
Foreign bank Affiliates**	630	3.3
Credit Unions	671	3.5
Financial leasing corp.	208	1.1
Sales Finance co's	3712	19.6
Trust companies	427	2.3
RoyNat	850	4.5
FBDB	2015	10.6
Provincial	1488	7.9
	$18930	100.0%

Source: Tables presented above and consultations with industry experts.

Note: * Includes SBLA
** Three year growth rate

The chartered banks collectively have a market share of 47%; since the real growth rate of the chartered bank's loans in this category was slightly below the market growth rate, it would appear that their market share has slipped slightly. The most significant loss of market share has been of the sales finance companies whose rate of growth has barely kept up with the overall economy.

The Federal Business Development Bank has a market share of 11%. This is the largest share of any single institution that operates in this market. While the chartered banks collectively have a larger share (47%), no single chartered bank has a share as large as the FBDB.

Table 37 below shows the total share of all the subsidized lending programs. These programs supported 24.8% of the total market. Since the bulk of the subsidized lending takes place under authorizations below $1 million, it can be assumed that the market share of these programs will be significantly higher in that market segment.

Note that the above estimates do not include subsidized lending under the SBDB program. If current estimates of the extent of lending under this program are accurate, the inclusion of SBDB loans would push the share of subsidized lending to something over 30%.

Table 37

MARKET SHARE OF SUBSIDIZED LENDING

1980

	$ million
Total term loan market below $5 million	19,000
Subsidized term loans	4,588
Subsidized as % of total	24.1%

Further, there is some reason to believe that the subsidized lending programs have a higher market share in the Atlantic provinces and in Quebec than they have in other provinces. Indeed, if it were possible to calculate market shares by province in the term loan market under authorizations below $1 million, it is quite likely that in some provinces the subsidized programs support more than 50% of the market.

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