A Review of the Small Businesses Loans Act (SBLA) Program

Prepared for:

Industry, Science and Technology Canada
Western Economic Diversification Canada
Atlantic Canada Opportunities Agency

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February, 1992

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& ASSOCIATES LTD.

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Table of Contents

Summary of Conclusions and Recommendations

In this summary the main issues comprising the Terms of Reference for this Review will be addressed.

1. Program Utility

Conclusion

The Program does respond to the debt financing needs, in the area of secured lending, of a significant portion of Program users. A significant proportion of borrowers (63%) stated that at the time they arranged an SBLA loan, no alternatives to this loan were available. While one-half of the Program's borrowers use the Program because of the interest rate, the actual interest rate benefit is not significant in ensuring the financial viability of a business. As well, consideration should be given to the likelihood that the financial markets may be operating to ensure an efficient marketplace (e.g. rejection of financially weak borrowers), when contemplating the finding that 25% of Program users experienced recent difficulties in obtaining financing. The Program is particularly relevant to business start-ups, businesses in sectors having a higher than average risk of business failures (e.g. franchises and restaurants) and for certain classes of business improvements (e.g. leasehold improvements) where the asset upon which the loan is secured cannot be easily liquidated.

As other evaluations or reviews of the SBLA have concluded, the Program is not well focused in terms of its objectives. No operational objectives have been developed to assist lenders in identifying what the Program is trying to achieve. We do not believe that the objective first inserted in 1987 to "increase the availability of loans ...." represents a sufficiently ambitious objective given the declining federal government funding available for programming. As it stands, the Program could administer a handful of loans and seemingly satisfy its objectives.

Recommendation

While the Program does respond to a need, the benefit occurs in the form of making more capital available than would be the case in the absence of the Program. The financial benefits that accrue to small business as a result of receiving a lower interest rate than otherwise would be possible, are not likely to be large. In this context, it is worth examining alternative ways of obtaining more leverage for the government's investment.

Meaningful objectives should be developed for this Program. In doing this consideration should be given to the following issues:

- To what extent does the Program operate in sectors where SBLA borrowers benefit at the expense of their Canadian competitors?

- If business start-ups and other high risk borrowers represent the majority of incremental borrowing, should other borrowers be eligible?

- What volume of lending is desirable under the Program and what level of loan losses are acceptable?

2. Program Parameters: Should they be Changed?

Conclusion

Lenders would like to receive a user fee and would like to be able to use the Program to make larger loans to larger businesses. A user fee could be given to the lenders without impacting Program borrowers, however, the Program would have lost an opportunity to recover more of its costs. For example, lenders could receive a portion of the government's user fee in exchange for a reduced loan loss coverage ratio and the Program could remain revenue neutral. Alternatively, borrowers could have their user fee increased by ¼% and these moneys could be used to satisfy the demands of lenders. The impact of this would be to reduce the number of "good credit risks" using the Program as they would likely receive a lower cost loan using conventional lending instruments.

Increasing the eligible loan and business size amounts would result in increased costs to the government. The major impact of the changes would be on larger, established businesses since start-ups are typically not eligible for $250,000 loans and typically do not commence business having sales of $5 million.

The 1988 evaluation of the Program concluded that the loss sharing ratio for the SBLA be reduced from its current 85% of loan losses to 80%. There could be some reduction in total lending under SBLA resulting from such a change, however, we believe the impacts would be minimal.

We do not believe that there is strong support on the part of borrowers for adjusting the program parameters according to the amount of risk in the borrower's business. Lenders currently, using conventional lending instruments, adjust the amount of credit that will be made available according to perceived risk and they can alter the interest rate accordingly conventional lending instruments. Allowing lenders to increase loan pricing according to perceived risk will, in our opinion, result in better returns to lenders with minimal benefits for borrowers.

Recommendation

If the Program's objective is to "increase the availability of loans for..." then giving the lenders what they want will accomplish this to a greater extent, however, as noted the impacts on the Program's incremental borrowers are likely to be minimal. The problem clearly lies with the Program's objectives - once it is known, in terms more precise than currently exist, who requires assistance and to what extent, the choice of appropriate mechanisms required to achieve the objective is relatively straight forward.

We recommend that Program parameters not be varied to take account of business risk.

3. Do Differences in Financing Availability Exist Among the Provinces

Conclusion

We could find no significant evidence of differences in the small business financing environment among provinces in Canada.

Traditional lenders to the business community may be withdrawing services to smaller rural centres where branches have not been profitable. In this regard, Credit Unions may fill the void, however, their commercial lending experience and the availability of corporate support is not present to the same extent as would be found with the larger lenders. The potential impact of this on Program loan losses has not been established.

Recommendation

We recommend that Program parameters not be adjusted according to geographic location. Most lenders would not support such changes and stated that the added complications would reduce Program usage by the lenders.

4. Extent of Program Awareness

Conclusion

The majority of borrowers are aware the Program is funded by the Government of Canada. Borrowers, in the main, learn of the Program from lenders. Increasing Program awareness will likely result in increased Program activity and costs. At the same time it is not clear that incremental benefits will accrue to the Canadian economy as a consequence of this action.

Recommendation

The current objectives for the Program include all small businesses as potential clients. As such, attempts, through general advertising methods, to make all potential clients aware of the Program are likely to be expensive. If more Program activity is desirable, then small business intermediaries (e.g. accountants and lenders) are likely to represent cost effective sources for increasing Program awareness. However, we recommend that Program awareness not be increased until the target audience is better defined by the Program's objectives.

5. Program Administration Considerations

Conclusion

The claims process and the regulations governing the provision of original receipts for all expenditures related to the SBLA loan continue to be a significant irritant to lenders (Chartered and Non-Chartered) and a barrier to increased usage of the Program.

Recommendation

We understand that a Review of the Administration of the SBLA is underway and that the above noted problem is addressed by the Terms of Reference for this Review. As such, no further action should be undertaken until this Review is complete.

1.0 Introduction

1.1 Background

The Small Businesses Loans Act (SBLA) came into effect in 1961. As stated in the Act, the objective of the program is "to increase the availability of loans for the purpose of the establishment, expansion, modernization and improvement of small business enterprises."

The following are the most significant changes that have been made to the legislation since 1961:

1. In 1971, the maximum loan amount outstanding to any one borrower at any one time was increased from $25,000 to $50,000 and a small business enterprise was redefined as one with estimated annual gross revenue not exceeding $1,000,000.

2. In 1977, the total amount permitted to be outstanding to any one borrower at any one time was increased to $75,000 and a small business enterprise was redefined as one with estimated annual gross revenue not exceeding $1,500,000.

3. In February 1978, the formula establishing the maximum interest rate permitted to a lender was changed from a fixed rate established semi-annually to the prime rate of the chartered banks plus 1 percent, floating with the prime rate for the term of the loan.

4. In July 1980, the maximum total loan amount outstanding to any one borrower at any one time was increased from $75,000 to $100,000.

5. In April 1985, a small business enterprise was redefined as one with estimated annual gross revenue not exceeding $2,000,000. A requirement was introduced for the payment by lenders, to the government, of a one percent up-front fee at the time a loan is made. Also introduced was a loss-sharing arrangement whereby, instead of effectively paying a lender's total loss, the government shares losses on individual loans in a ratio of 85 percent government/15 percent lender.

6. On March 20, 1990, legislation was approved to extend the program on a status quo basis for a period of three years, commencing March 31, 1990. During the course of the extension, the federal government is to undertake an examination

of the program. This present review is to be one element of the overall examination.

The interest rate change of February 1978 is of particular significance since the volume of SBLA lending increased dramatically because lenders were now sufficiently remunerated to motivate widespread lending under SBLA.

Since the inception of the Act, all banks under The Bank Act have been approved as lenders. In March 1970 the provisions of the Act were widened to include all credit unions, caisses populaires, trust, insurance and loan corporations which, upon request, are designated by the Minister as banks for the purposes of the Act. The Alberta Treasury Branches were included as approved lenders in 1974.

Eligible borrowers include any enterprise in Canada operating for gain or profit provided the estimated gross revenue of the applicant does not exceed $2 million during the fiscal year in which the business improvement loan application is made. Eligible entrepreneurs must be from the following sectors: communications; construction; fishing; manufacturing; retail trade; service businesses; transportation; and, wholesale trade.

Loans are available for the purpose of financing: the purchase of land necessary for the operation of a business enterprise; the purchase of software; the renovation, improvement, modernization, extension, construction and/or purchase of premises; the purchase, installation, renovation, improvement and/or modernization of equipment of a kind whether affixed or not affixed to real or immovable property.

Loans are not available for the purpose of financing: the acquisition of shares; working capital (i.e. inventory, book debts, etc.); existing debt; and, goodwill or other intangibles.

Whereas up to mid-1987, DRIE/ISTC had full program responsibility, this has since been changed with the coming into being of the Atlantic Canada Opportunities Agency (ACOA) and the Department of Western Economic Diversification (WD). Since June 1987 and August 1987 respectively, ACOA and WD have shared SBLA responsibility with ISTC. The operational aspects of the program are handled centrally by ISTC.

1.2 Scope of the Review and Methodology

While these issues are presented in detail in Appendix A, the main points include:

- issues related to the utility of the Program from both a borrower's and lender's perspective;
- issues related to the Program's parameters and whether they should be changed;
- issues examining whether differences exist amongst the provinces in terms of the availability of financing;
- issues related to the extent of Program awareness by its beneficiaries; and,
- issues related to the administration of the Program.

This current Review follows an Evaluation of the Program that was completed in 1988. While the Evaluation addresses the Program from a national perspective, this Review is focused upon provincial and regional differences that may exist in Program requirements. As well, the current Review addresses issues from the perspective of non-chartered lenders and for the first time, Program borrowers. In the 1988 Evaluation only Chartered Bank lenders were surveyed.

The methodologies used to address these issues comprised the following:

- a telephone survey of a random sample of some 500 businesses (50 per province) having received at least one SBLA loan in the year ending in March 1991. The results, at a provincial level, from this survey are accurate, at a 95% level of confidence, within $\pm$ 14% for dichotomous (i.e. yes/no) survey variables;
- a mail, census survey of some 600 non-chartered bank lenders (Managers at the branch level) who had made at least one SBLA loan in the past year;
- seven focus groups conducted in Vancouver, Edmonton, Saskatoon, Winnipeg, Ottawa, Montreal and, Halifax. The focus group members, in the main, consisted of personnel with small business lending experience and familiarity with the Program. Focus group participants included branch managers from Chartered and non-chartered lenders, regional credit managers and loan officers from banks and credit unions;

- in-person interviews with personnel from the Federal Business Development Bank, Western Economic Diversification, Atlantic Canada Opportunities Agency, Canadian Organization for Small Business and, the Canadian Association for the Advancement of Technology; and,

- a review of documentation from such sources as the 1988 Evaluation of the SBLA Program, the Program administrative data base and, information on the U.S. Small Business Administration's guaranteed loans program.

2.0 Findings

The findings (where warranted, because of the volume of information) are organized by major topic area. In those instances where a large amount of information is available, a summary of the findings is presented relative to each issue comprising the Terms of Reference. Regional or provincial findings are not presented unless they are statistically different from the findings at the national level of aggregation.

2.1 Program Utility

Borrower's Survey

- 63% of borrowers surveyed responded that **no** alternatives to the SBLA loan were available at the time the loan was made.

- 37% of borrowers responded that alternative loans were available. Of these, the majority stated that alternatives were available for the same loan size; within the same time frame; from the same lender; and, with similar collateral arrangements. While 37% of borrowers stated that an alternative to the SBLA loan was available, most stated the alternative was not available at the same interest rate;

- 51% of SBLA borrowers chose the SBLA loan because it offered the best available interest rate. This was the case for 74% of Ontario borrowers, 68% for B.C. while only 25% of Quebec borrowers said that this was the reason for choosing the SBLA loan. The remaining provinces did not significantly differ from the national average. Only 23% of borrowers stated that the their reason for choosing an SBLA loan was because less collateral was required. An additional 42% chose the SBLA loan because their lender suggested it. It should be noted that borrowers frequently identified more that one reason for selecting SBLA loans, therefore, total percentages across these multiple responses will exceed 100%;

- At the time they obtained their SBLA loan, 33% of borrowers required financing that was in addition to the SBLA loan. Regional differences to this figure were not significant. The main reasons cited for additional financial requirements were: total financing exceeded SBLA loan limits (52% of above respondents- 82% in NFLD.); and, addition loan amount was not eligible under SBLA criteria (51% of above respondents;

- 25% of SBLA borrowers stated that they experienced **difficulties** in obtaining financing within the past 3 years. Regional differences were not significant from this finding. For the 25% of SBLA borrowers who experienced difficulties in obtaining financing during the past 3 years, 25% stated that the interest rates were not sufficiently attractive; 63% said they were not able to provide sufficient collateral; and, 61% stated that the financial institutions would not provide financing. Of this latter group, the most frequent reasons given to the borrower by the lending institutions for not lending were:

  - lack of collateral (16%);
  - business was judged to be high risk (15%);
  - firm was not in business for sufficient time (14%);
  - insufficient cash flow (8%).

- when borrowers were asked if they would use the SBLA Program to meet future financing requirements, 91% responded that they would. There were no significant provincial differences to this response.

Lender's Survey

- When non-chartered bank lenders were asked if the terms (interest rate and user fee) should be varied to take account of a number of factors, they responded as follows:

  - 46% stated that terms should be varied to reflect the age of the business;
  - 45% would vary the terms of the loan according to the economic sector of the applicant;
  - 56% would vary the terms according to the purpose of the loan; and,
  - 17% would vary the terms according to the geographic area of the applicant.

- If the terms (interest rate and user fee) for the SBLA loans were varied, as suggested by the above factors, 32% of lenders were of the opinion that the volume of lending under the Program would increase; 52% stated the volume of lending would stay the same; and, 12% stated the volume of lending would decline even though the terms were changed.

- SBLA loans are frequently "packaged" with other types of loans. From our survey of lenders, 53% of respondents reported that more than 50% of SBLA loans are packaged; 34% indicated that SBLA loans are packaged in more than 70% of all instances of SBLA lending. The reasons for packaging SBLA loans were as follows:

- 43% of respondents packaged SBLA loans are packaged to provide a blended, reduced rate of interest to the borrower;
- 76% of lenders sought to reduce the lender's risk of loan loss;
- 69% of SBLA lenders packaged loans to increase the amount of money that otherwise would be provided to the borrower.

- when lenders were asked to what extent eliminating the SBLA would reduce lending to small businesses, they responded by stating that lending would decline by an average of 19%. Respondents stated that this decline in lending would impact: new businesses (80% of respondents); and, the value of loans made available to typical small business borrowers (75% of respondents);

- While 69% of lenders viewed the Program as a useful additional service that provides the borrower a loan at a lower cost and, 62% stated that it permitted loans where security was not easily liquidated e.g. leasehold improvements, only 27 % saw SBLA loans as being applicable to high risk businesses that could not obtain conventional loans.

- Lenders estimated that 49% of SBLA borrowers were dependent upon SBLA loans to complete their projects or acquire assets. However, lenders also stated that 42% of SBLA borrowers would have received a loan without the SBLA guarantee.

Focus Groups

- SBLA loans are frequently used to finance hard to liquidate assets such as leasehold improvements; for financing high risk businesses such as restaurants and franchises; and, for business start-ups;

- SBLA loans are frequently packaged with conventional loans because often the borrower does not have sufficient security to warrant additional funding and the guarantee does provide a level of comfort. As well, SBLA loans are packaged to provide both the lender and the borrower with a blended rate of interest. From the borrower's viewpoint the blended rate is lower while from the lender's viewpoint the rate is higher than is attainable with using only an SBLA loan. This packaging also occurs because the SBLA loan limit is frequently insufficient to cover the total amount to be financed or other SBLA criteria cannot be met for the total amount required;

- In Eastern Canada there was concern that many businesses were under capitalized and that the Program contributed to this problem by allowing for 90% financing in some instances. There are a lot of competing Programs (Eastern Canada) and it is difficult to see the niche the Program is addressing. Additionally, there is a lot of stacking of government funding and the entrepreneur is not putting enough of his own money in the business to ensure he won't walk away from the business during difficult times;

- In Western Canada there was a perception that the banks were abandoning the rural areas and the Credit Unions were beginning to respond to the increase in demand for commercial lending. The point was made that since Credit Unions are each independent organizations and very small, the consequences of a single loan failure could be quite severe. For this reason the SBLA guarantee was very important to the Credit Unions; and,

- The Program should be focused with clear objectives.

Summary of Results

- **Does the program respond to genuine debt financing needs of small business?**

It is important when addressing this issue to realize that the Program is used for secured lending. In this context the Program provides the lender with additional security in an environment where the lender feels that you can never have too much security. One half of the borrowers choose to use the Program because of the interest rate, while 23% used the Program because less collateral was required. As well, 63% of borrowers stated that at the time they arranged an SBLA loan, no alternatives to this loan were available. While a significant proportion (75%) of borrowers experienced recent difficulties in obtaining financing during the past three years, lenders are of the opinion that 42% of SBLA borrowers would have received a loan without the Program. If banks are indeed withdrawing service from rural areas, the Program may play an important role in allowing Credit Unions to fill this void.

From the viewpoint of both borrowers and lenders, the Program does respond to the debt financing needs of a significant portion of the Program users.

Conclusion

The Program does respond to the debt financing needs, in the area of secured lending, of a significant portion of Program users. While one-half of the Program's borrowers use the Program because of the interest rate, the actual interest rate benefit is not significant in ensuring the financial viability of a business. As well, consideration should be given to the likelihood that the financial markets may be operating to ensure an efficient marketplace (e.g. rejection of financially weak borrowers), when contemplating the finding that 25% of Program users experienced recent difficulties in obtaining financing. The Program is particularly relevant to business start-ups, businesses in sectors having a higher than average risk of business failures (e.g. franchises and restaurants) and, for certain classes of business improvements (e.g. leasehold improvements) where the asset upon which the loan is secured cannot be easily liquidated.

Recommendation

While the Program does respond to a need, the benefit occurs in the form of making more capital available than would be the case in the absence of the Program. The financial benefits that accrue to small business as a result of receiving a lower interest rate than would be possible, are not likely to be large. In this context, it is worth examining alternative ways of obtaining more leverage for the government's investment. One alternative worthy of examination would be the U.S. loan program for small businesses. This Program allows the financial institutions to use the leverage they obtain from the U.S. governments guarantee to expand their capital base and create a secondary capital market for small business financing.

- **Are there any differences in terms of the need for this program by province, location (urban/rural), sector, stage/size of business?**

While our findings could not discern differences in the need for this Program at a provincial level, the Program would appear (this requires more investigation) to be increasingly important for rural areas and for sectors that are perceived as having more risk e.g. restaurants and franchises. The Program is definitely more important to business start-ups than established businesses.

Conclusion

Business start-ups and small businesses in sectors perceived as having a higher risk need the Program to a much greater extent than well established businesses (those that have been in business 5 or more years) and businesses in sectors with business failures that are more in keeping with the average failure rates for all sectors. As well, Credit Unions, if they are to play a significant role in delivering the Program to businesses in rural areas, may need the Program to insure against potential insolvency of the financial institution. This need arises since the Credit Unions are typically very small in terms of their capital base and the consequence of a loan failure of any significance can be quite severe. The SBLA guarantee provides much needed insurance for the Credit Unions.

Recommendation

The Program's parameters should not be adjusted on a provincial basis. The importance of commercial lending by the Credit Unions to small businesses in rural areas should be investigated further to determine the significance of the Program to rural borrowers.

- **What is the nature of the assistance provided by the program to small business (increased access to capital, reduction in collateral requirements, better terms and conditions for supplementary financing, improved financial situation, etc.)?**

Given that one-half of the SBLA borrowers choose the Program because of the preferred interest rate, it is important to examine the economic benefit this confers on small business. The average SBLA loan is about $40,000 and we estimate that a typical non-SBLA loan has an interest rate of about prime plus 2%. If we take the Net Present Value (NPV) of the interest saving due to the Program, over 10 years discounted at 10% (equivalent to the social cost of capital typically used by Treasury Board) we arrive at a gross savings (on a NPV basis) to the borrower of less than $1600. Of course we have to subtract from this the negative fiscal impacts associated with paying for the loan losses and Program administration. The point of this crude exercise is to demonstrate that the benefits conferred by the interest rate subsidy are not of a large magnitude and the real benefit comes from improving the availability of capital rather than the cost of capital.

The Program is not likely to reduce the requirement for collateral but rather, in certain instances, increase the amount of debt financing available for a given amount of collateral.

Our findings suggest that better terms and conditions are available for supplementary financing under the Program, however, as the above analysis indicates, the financial benefits to the borrower, resulting from a reduction in interest rate because of the SBLA guarantee, of this are not large.

Conclusion

In the main, the Program improves, for business start-ups and other high risk businesses, access to capital. The economic impact of the reduced interest rate is not significant in terms of its impact on the specific business borrower.

Recommendation

Given that the impacts of the Program are largely restricted to improving the access to capital for business start-ups and other high risk businesses, policy makers should determine the extent to which this type of assistance represents a spending priority.

- **Is the objective of the program appropriate in the current environment of small business lending?**

The objective for the Program is to increase the availability of loans for the purpose of the establishment, expansion, modernization and improvement of small business enterprises. The lenders, who are the delivery agents for the Program, do not understand what the Program is trying to accomplish and some have expressed concerns as to whether or not there is a niche for the Program. The Program is not specifically targeted at those who appear to most need it - business start-ups and there are no operational objectives that would allow for a determination of when needs have been satisfied in the context of the cost of the Program. One might reasonably ask that given the recent economic recession and its likely significant impact on loan losses, whether increasing the availability of loans represents a sufficiently ambitious objective. Many lenders, and we concur with this opinion, believe that the objectives for the Program are not appropriate in that they are not sufficiently specific.

Conclusion

As other evaluations or reviews of the SBLA have concluded, the Program is not well focused in terms of its objectives. No operational objectives have been developed to assist lenders in identifying what the Program is trying to achieve. We do not believe that the objective first inserted in 1987 to "increase the availability of loans ...." represents a sufficiently ambitious objective given the declining funding available to provide assistance to business. As it stands, the Program could administer a handful of loans and seemingly satisfy its objectives.

Recommendation

Develop meaningful objectives for this Program. In doing this consideration should be given to the following issues:

- To what extent does the Program operate in sectors where SBLA borrowers benefit at the expense of their Canadian competitors?
- If business start-ups and other high risk borrowers represent the majority of incremental borrowing, should other borrowers be eligible?
- What volume of lending is desirable under the Program and what level of loan losses are acceptable?

- **Why do lenders utilize the program?**

In the main lenders use the Program for loans where the security is difficult to liquidate; for business start-ups; and, for businesses that represent higher risks e.g. restaurants and franchises.

Conclusion

Lenders are increasingly using the Program for loans that represent more risk than they may be willing to finance without the benefit of the Program. However, it must be remembered that this type of lending is still secured and does not represent what would normally be thought of as risk capital. Because a significant proportion of lenders perceive that the Program offers a limited financial return, the proportion of SBLA loans viewed by lenders as having more risk is likely to increase in the SBLA portfolio.

Recommendation

If the objectives for the Program include assisting businesses in arranging loans that represent what lenders view as carrying higher than normal risk, then the current Program direction should be encouraged.

2.2 Program Parameters: Should they be Changed?

Borrower's Survey

- When borrowers were asked about the impact of increasing the SBLA interest rate, they responded as follows:

  - 71% stated that an increase of ½% would have no impact,
  - 51% stated that an increase of 1% would have no impact; 32% said no loan would be taken at this rate; and, 15% said a smaller loan would have been taken,
  - 43% stated that an increase of 1 ½% would have resulted in no loan being taken; 39% said this increase would have no impact; and, 15% said a smaller loan would have been taken.

- When borrowers were asked about the impact of increasing the SBLA user fee, they responded as follows:

  - 65% stated that an increase of ½% would have no impact,
  - 48% stated that an increase of 1% would have no impact; 39% said no loan would be taken at this rate; and, 11% said a smaller loan would have been taken,
  - 44% stated that an increase of 1 ½% would have resulted in no loan being taken; 40% said this increase would have no impact; and, 11% said a smaller loan would have been taken.

- Borrowers were asked whether some of their business assets were used as security for the SBLA loan. While 80% responded "yes", 19% stated that this form of security was not taken. It should be noted that it is a Program requirement that assets associated with the loan be pledged as security;

- When borrowers were asked if personal assets were required to secure their SBLA loan, 66% replied "no" and 34% said "yes". When this latter group were asked about the impact of eliminating this requirement for a personal guarantee, the responses were as follows: 57% stated this would have no impact and 36% stated they would have taken out a larger loan than they otherwise received. Regional differences to these responses were not significant;

- 88% of borrowers stated that a $100,000 SBLA loan limit was sufficient to satisfy their past financing requirements. Of the 12% of borrowers who responded that $100,000 was not sufficient, 68% said that between $100,000 and $200,000 was required and 29% stated that between $200,000 and $400,000 was required. When borrowers were asked about their future loan requirements, 52% stated that the current $100,000 limit was sufficient; 13% said between $100,000 and $200,000 was required and 10% stated that between $200,000 and $400,000 was required; and, 15% said they had no future requirements.

Lender's Survey

- When non-chartered bank lenders were asked what changes should be made to the SBLA interest rate, 55% responded that it should remain the same; and, 38% stated it should be equal to the rate charged for conventional loans. Regional variations were not significant;

- 79% of lenders stated that they should be allowed to charge their own user fees in addition to those charged by the government. On average they felt that their portion of the fee should be about 0.4% of the value of the loan. Expressed as a flat rate, 72% were of the opinion that their portion of the fee should be $100 or less. 85% of these lenders currently charge fees for conventional loans;

- when asked about the impact on the Programs's total population of clientele from increasing the user fee to 1.5%, they responded as follows:

  - 71% stated that lending to new businesses would remain the same,
  - 65% stated that lending to firms that were a "good" credit risk would decrease,
  - 78% were of the opinion that loan losses would remain the same,
  - 50% stated that total lending under the Program would remain the same while 47% were of the opinion that total lending would decline.

- When lenders were asked whether the Program's terms (interest rate and user fee) should be varied to take account of a number of parameters, they responded as follows:

  - 54% stated that the terms should not be varied to take account of the age of the business,
  - 55% stated that no account be taken of the sector in which the business is operated,

- 56% responded that the terms should be varied according to the loan purpose,
- 83% were of the opinion that terms should not be varied according to geographic location.

- when lenders were asked about the impact of decreasing the loan loss coverage from 85% to 80%, they responded as follows:

  - 63% were of the opinion that lending to new businesses would decrease,
  - 57% thought lending to businesses that were a "good" credit risk would remain the same,
  - 43% stated that loan losses (from lender's perspective) would remain the same, while 31% thought losses would decrease,
  - 60% were of the opinion that total lending under the Program would decline.

- When lenders were asked the extent to which their branch required personal guarantees to secure SBLA loans, 23% replied "occasionally"; 38% "usually"; 36% "always"; and, 3% "never".

- When lenders were asked about the impact of eliminating the requirement for personal guarantees under the Program, the responses were as follows:

  - 27% were of the opinion that lending under the Program would increase; 34% felt lending would stay the same; and, 39% thought lending would decrease;
  - 64% were of the opinion that loan losses would increase; and 34% thought loan losses would remain the same.

Focus Groups

- Participants in the focus groups were emphatic that the Program should be kept as simple as possible and that changes should not be made to take account of perceived regional differences. They stated that businesses across Canada are managed using the same principles and their credit worthiness is judged by all lenders using similar criteria. Furthermore, borrowers would be angry if a given financial institution offered different terms dependent upon geographic location - Ottawa versus Hull for example;

- While the largest proportion of participants were satisfied with the current interest rate for SBLA loans, most (not the Credit Unions) participants stated that the lending institutions should receive a user fee. A frequently mentioned fee was ¼% of the 1%

fee paid to the government. The minority of participants requesting a change to the interest rate structure, felt that interest rates should vary with business risk. A few participants stated that any increase to the interest rate could be shared with the government;

- A number of participants suggested that SBLA lending should be broadened to cover working capital requirements. While they state that such loans would be secured, they admit that while the loss rates are unknown, they are likely to be higher than for other, more conventional types of lending.

- A number of participants asked that the loan limit be increased to $250,000 and the size of eligible business be increased to $5 million in sales, the rationale being that the old limits have not be responsive to inflation and the financing requirements of small businesses have increased;

- A number of participants stated that SBLA loans should be transferable among financial institutions. As it stands now, the lack of transferability is a barrier to competition. Further, when an account moves to another institution the SBLA loan remains behind and it is almost impossible, because of the lack of customer contact, to monitor business performance; and,

- Some participants stated that the current 90% financing for some assets should be reduced to 75% to encourage owners to put more equity into their business.

Summary of Results

- **Should there be a change in the particular program parameter. If so, how should the program parameter be changed, and what would be the rationale for making the change?**

- **What would be the impact of changing program parameters, including considerations such as program activity, risk profile of program clients, cost of the program, achieving the objective of the program, etc.?**

- **How does the fee structure of the program compare to the use of fees for similar commercial small business loans?**

- **Should lenders be allowed to charge fees under the program which would be in addition to those presently designated by the federal government? If so, what**

should the fees be, and what would be the potential impact of the imposition of fees?

While there are numerous requests from the lending institutions for an increase in interest rates, the most sought after source of additional revenue would appear to be user fees for lenders. The lender's argument is that time spent on SBLA paperwork should be paid for. The fee most often asked for (in the focus groups) is ¼% of the value of the loan on a one time basis. Based upon 1990 figures for the Program, this would cost borrowers or the Program, depending on how it was funded, about $1 million. While this increase would have minimal impact on borrowers, particularly business start-ups, it would represent a lost opportunity for cost recovery on the part of the Program. However, the imposition, on behalf of the lender, of an increase to the user fee would eliminate some of the barriers which may be inhibiting Program usage by lenders.

As well, a significant number of lenders requested an increase to size of eligible loan and business. The numbers most frequently mentioned were increasing the eligible loan size to $250,000 and the eligible business size to $5 million. Increasing the eligible loan size and business size would lead to an increase in lending under the Program, however, the magnitude of this increase is difficult to predict.

While a number of lenders suggest that the Program be expanded to include secured lending for working capital, they admitted that loan loss rates for this type of lending were likely to exceed that for the Program as it currently exists.

The narrative to follow, presents a view (as expressed by Goss, Gilroy & Associates in the 1988 SBLA Evaluation) as to how various program parameters are interdependent and what would be the likely impact (in general terms) of a change in a specific parameter.

The first point that needs to be made is that all of the program elements (interest rate, loan loss ratio and, program administration fee) comprising the pricing of SBLA loans are interrelated and changes to any one element will impact on the various players associated with the Program in different ways. For example, increasing the user fee results in added costs to borrowers and added revenue to government but is neutral, in terms of financial impact, from the lender's viewpoint. In the same way, increasing interest rates adds to the cost of borrowing, adds revenue for lenders and, is neutral from the governments financial viewpoint. In terms of the loan loss sharing ratio, reducing that portion of loans losses reimbursed by the government increases costs to lenders but is neutral from the viewpoint of financial impact on borrowers.

The second point to consider is derived from "price theory". In its simplest form price theory tells us that when the price of a good or service increases, demand for this good or service declines. In terms of the SBLA Program the implications of this theory are that when the cost to borrowers increases, demand for the Program declines. However, this is too simplistic a statement to be of much practical use in analyzing the impact of pricing changes on borrowers.

Borrowers using the SBLA Program can be classified into two categories: good credit risks who would have received a conventional loan if SBLA was not available or desirable; and, incremental borrowers who include new businesses and businesses in emerging technologies - this type of borrower is not as good a credit risk from the lender's viewpoint.

Good credit risks are price sensitive because they can afford to be. Borrowers belonging to this group can obtain a loan using other conventional lending instruments. An increase in interest rates or an increase in the user fee will cause the demand for the Program to decline with this type of borrower. In a typical governmental program it would be desirable to eliminate this type of program user. The SBLA Program however, is significantly different from other programs in the following ways. In the first instance, there is no cost to government of including good credit risks in the Program unless this type of borrower defaults on an SBLA loan - because they are good credit risks to begin with, they will default less often than incremental borrowers. The government does not incur significant administrative costs for Program participants who do not default on SBLA loans. In the second instance, good credit risks pay a user fee which helps cover a portion of the government's costs for the Program.

Incremental borrowers on the other hand, are not price sensitive within the practical range of price increases which could be considered for the SBLA Program. For these types of borrowers it is the availability of capital rather than the cost of capital which is significant. Given the average size of SBLA loans and the purposes for which capital is required, this type of borrower is not a good candidate for equity markets and would not typically qualify for a conventional loan under the same terms and conditions as SBLA i.e. loan security requirements would be more stringent.

As a third point for consideration, the attitudes of lenders in terms of SBLA pricing and the current environment surrounding banking institutions have important consequences for proposed changes to the pricing of SBLA loans. In terms of lender's attitudes towards SBLA loan pricing, lenders want more revenue but are likely to be indifferent as to whether increased revenue is derived from an imposition of their own user fee, an increase in interest rates or, an increase in the government's portion of the loan loss sharing ratio.

In terms of increasing the SBLA interest rate, lenders have stated a preference for being able to charge a rate that would vary in accordance with their assessment of risk associated with the borrower. The current rate structure allows interest to be charged at the Prime interest rate plus a fixed interest premium. To move to a variable interest rate would not allow the Government to maintain the same control as it now has over future liabilities associated with the Program. Specifically, a variable interest rate allows lending institutions to price their loans in accordance with the perceived risk. While revenue in the form of interest rates accrue to lenders, the bulk of the risk (currently 85%) accrues to the Government. A variable interest rate may provide an incentive for lenders to increase the risk in their portfolios of SBLA loans with the major portion of costs would have to be absorbed by the SBLA Program.

The size of eligible loan, the size of eligible business and collateral requirements all impact on the risk associated with the portfolio of loans outstanding at any one point in time. For example, very small businesses are often in a start-up mode and therefore have more risk associated with them than a larger business which may be well established. The difficulty comes with selecting a meaningful attribute to measure business size - $2 million a year in sales volume may be large in the service sector but very small in wholesale trade for example. If the eligible size of business were to be increased, more firms would become eligible under the Program, the volume of lending would likely increase but this incremental lending would presumably be to larger and more stable businesses.

If collateral requirements were to be reduced or eliminated, then for those loans in default, it would not be possible for the lenders and hence the government to recover monies from the sale of pledged assets to offset loan losses. Costs to both lenders and the Government would increase pro rata with the loss sharing agreement. As well, this opens up the opportunity for lending to higher credit risks, those without or with reduced collateral, and moves away from the requirement for lenders to use "normal lending practices" for SBLA loans.

Adjusting either the loan purpose or the sector eligibility impacts on loan eligibility and will serve to expand or contract the value of the loan portfolio accordingly. This is more a question of access than pricing, however, total exposure to loan loss will change proportionately with either an increase or decrease in the amount lent under the Program.

Conclusion

Lenders would like to receive a user fee and would like to be able to use the Program to make larger loans to larger businesses. A user fee could be given to the lenders without impacting Program borrowers, however, the Program would have lost an opportunity to recover more of its costs. For example, lenders could receive a portion of the government's user fee in exchange for a reduced loan loss coverage ratio and the Program could remain revenue neutral. Alternatively, borrowers could have their user fee increased by ¼% and these moneys could be used to satisfy the demands of lenders. The impact of this would be to reduce the number of "good credit risks" using the Program as they would likely receive a lower cost loan using conventional lending instruments.

Increasing the eligible loan and business size to the requested amounts would result in increased costs to the government. The major impact of the changes would be on larger, established businesses since start-ups are typically not eligible for $250,000 loans and typically do not commence business having sales of $5 million.

The 1988 Evaluation of the Program concluded that the loss sharing ratio for the SBLA be reduced from its current 85% of loan losses to 80%. There could be some reduction in total lending under SBLA resulting from such a change (as indicated by the lender's survey for this review), however, we believe the impacts would be minimal.

Recommendation

If the Program's objective is to "increase the availability of loans for..." then giving the lenders what they want will accomplish this to a greater extent, however, as noted the impacts on the Program's incremental borrowers are likely to be minimal. The problem clearly lies with the Program's objectives - once it is known, in terms more precise than currently exist, who requires assistance and to what extent, the choice of appropriate mechanisms required to achieve the objective is relatively straight forward.

- **Should program parameters be varied to take into account sectoral, stage of business, type of project, etc., difference? From the borrower's perspective, there does not appear to be a lot of demand for increasing the eligible loan size.**

A number of lenders expressed the opinion that pricing of SBLA loans should vary with business risk. If the lending institutions were allowed to keep all revenues from any increase in pricing, and pricing was adjusted to agree with conventional lending practices, what would be the incentive for either the borrower or the lender to use SBLA except in cases involving ever increasing levels of risk. Increasing the interest rate, for example, would allow banks to be compensated for taking more risk. With the Program absorbing 85% of loan losses, leverage in this instance will always be in favour of the lending institutions.

Conclusion

We do not believe that there is strong support for adjusting the program parameters according to the amount of risk in the borrower's business (the above examples e.g. sector etc. all can be thought of a factors affecting risk). Lenders currently, using conventional lending instruments, adjust the amount of credit that will be made available according to perceived risk and they can alter the interest rate accordingly conventional lending instruments. Allowing lenders to increase loan pricing according to perceived risk will, in our opinion, result in better returns to lenders with minimal benefits for borrowers.

Recommendation

We recommend that Program parameters not be varied to take account of business risk.

- **To what extent are personal guarantees being used by lenders for SBLA loans?**

- **What would be the impact on the program if lenders were not allowed to take personal guarantees?**

According to borrowers, personal guarantees were required for about 34% of SBLA loans. From a borrowers perspective loan size would increase somewhat although the overall impact would appear minimal. About 36% of lenders stated that they always required personal guarantees; 38% stated they usually required personal guarantees; and, 23% stated they occasionally required personal guarantees. A large proportion of lenders felt that eliminating personal guarantees would result in increased loan losses and the volume of lending would increase somewhat under the Program. Since the majority of loan losses are covered by the Program, the impact upon the lender is minimal. At the same time the impact on borrowers of this existing requirement would appear to be minimal.

Conclusion

Borrowers and lenders present conflicting views on the extent to which personal guarantees are required for SBLA loans. Borrowers are of the view that the impacts of providing a personal guarantee are minimal, while lenders believe that elimination of this requirement could increase the costs of the Program because of loan losses.

Recommendation

We recommend that the present practice continues and personal guarantees be taken when the lender's judgement results in a decision to do so.

2.3 Do Differences in Financing Availability Exist Among the Provinces

- **Are there differences in the small business financing environment among provinces in Canada and between urban and rural areas? If so, should specific program parameters be adjusted accordingly? How would the program parameters be varied?**

- **What would be the impact of differentiating the identified program parameters on the basis of province and/or urban/rural location?**

- **Are there variations across the country in SBLA loan practices as applied by lenders?**

Summary of Results

As our findings under other issue areas have demonstrated, we found no significant differences amongst the provinces in the small business financing environment that would warrant changes to any of the Program's parameters. We did note, however, that Credit Unions appear to be assuming a more prominent role in commercial lending in those rural areas where traditional lenders may no longer maintain branches. In terms of impact on the Program, from the viewpoint of volume of lending and loss rates, this does not appear to be significant as the volume of lending from these areas is relatively small in the context of total lending under the Program. The real issue is what role should the Program play in ensuring all areas have equal access to financing at competitive rates.

Differentiating Program parameters on the basis of province and/or rural location would, to some extent, alienate lenders who do not see a need and have expressed a strong preference for national consistency in the SBLA's terms and conditions.

Lender's appear to be using similar practices across the country in making SBLA loans. Any differences may be associated with Credit Unions who have a different relationship with their members/customers than other lending institutions.

Conclusion

We could find no significant evidence of differences in the small business financing environment among provinces in Canada.

Traditional lenders to the business community may be withdrawing services to smaller rural centres where branches have not been profitable. In this regard, Credit Unions may fill the void, however, their commercial lending experience and the availability of corporate support is not present to the same extent as would be found with the larger lenders. The potential impact of this on Program loan losses has not been established.

Recommendation

We recommend that Program parameters not be adjusted according to geographic location. Most lenders would not support such changes and stated that the added complications would reduce Program usage by the lenders.

2.4 Extent of Program Awareness

- **Do borrowers recognize the SBLA program as a federal government program?**

- **How could program awareness be improved, and what would be the implications of any suggested course of action?**

Summary of Results

The majority (77%) of SBLA borrowers were aware that the Program was funded by the Government of Canada. These findings do not significantly vary across provinces. The majority of borrowers (62%) learned of the Program from lenders with the next best source being accountants who suggested the Program to 9% of SBLA borrowers.

Conclusion

The majority of borrowers are aware the Program is funded by the Government of Canada. Borrowers, in the main, learn of the Program from lenders. Increasing Program awareness will likely result in increased Program activity and costs. At the same time it is not clear that incremental benefits will accrue to the Canadian economy as a consequence of this action.

Recommendation

The current objectives for the Program include all small businesses as potential clients. As such, attempts, through general advertising methods, to make all potential clients aware of the Program are likely to be expensive. If more Program activity is desirable, then small business intermediaries (e.g. accountants and lenders) are likely to represent cost effective sources for increasing Program awareness. However, we recommend that Program awareness not be increased until the target audience is better defined by the Program's objectives.

2.5 Program Administration Considerations

- **Do lenders have any particular comments/concerns regarding the administration of the program, including areas such as registration, paper burden, claims processing, communication with the federal government administration, etc.?**

Summary of Results

When lenders were asked whether the paper work requirements for various aspects of the Program were excessive, they responded as follows: 83% stated that the paper work requirements associated with loan registration were not excessive; 91% stated that reporting requirements were not excessive; 50% said that the paper work associated with claims was excessive, while 37% said it was not; 46% stated that the paper work associated with recoveries was excessive.

A common theme across all focus groups was the problems associated with the claims process and recoveries. Many lenders admitted that when past problems had occurred they often resulted from proper procedures not being followed by the lending institution. They also stated that the claims and recovery process was a large barrier to Program use. In particular they did not see the need to constantly harass borrowers for receipts, involving relatively small amounts of money, from a number of years in the past. These perceptions were noted as serious in the 1988 Evaluation and continue to be a major irritant today.

A number of participants in the focus groups wanted to know why the lenders' loan forms could not be used by the Programs Administration. They felt that all required information was contained on these forms. At a minimum they suggested that the Program's forms be made more user friendly as should other Program documentation.

Conclusion

The claims process and the regulations governing the provision of original receipts for all expenditures related to the SBLA loan continue to be a significant irritant to lenders (Chartered and Non-Chartered) and a barrier to increased usage of the Program.

Recommendation

We understand that a Review of the Administration of the SBLA is underway and that the above noted problem is addressed by the Terms of Reference for this Review. As such, no further action should be undertaken until this Review is complete.

- **Should the SBLA program be linked to other activities of relevance to small business development (e.g. information services, counselling, etc.)?**

Summary of Results

In the East Coast focus group participants expressed a view that with the number of firms experiencing financial difficulties, counselling related to financial management would be a useful offering;

In the interview with the Canadian Organization for Small Business, an opinion was expressed that business start-ups could be better assisted by funding "Incubation Centres" that provide advice on all business matters and, share experience and overheads. They claim that the success rate for business start-ups, using this concept, was far greater than what usually occurs without this type of support.

Conclusion

As demand for additional services were expressed in one focus group and one additional interview, we conclude that a strong demand does not exist for linking the Program to other activities of relevance to small business development.

Recommendation

We have no basis for recommending that the Program be linked to other small business services.

Appendix A:

Scope of the Review

Scope of the Review

The issues comprising the Review of the SBLA are as follows:

1. *Program Utility*

   - Does the program respond to genuine debt financing needs of small business?
   - Are there any differences in terms of the need for this program by province, location (urban/rural), sector, stage/size of business?
   - What is the nature of the assistance provided by the program to small business (increased access to capital, reduction in collateral requirements, better terms and conditions for supplementary financing, improved financial situation, etc.)?
   - Is the objective of the program appropriate in the current environment of small business lending?
   - Why do lenders utilize the program?

2. *Program Parameters; Should They Be Changed?*

   - Should there be a change in the particular program parameter. If so, how should the program parameter be changed, and what would be the rationale for making the change?
   - What would be the impact of changing program parameters, including considerations such as program activity, risk profile of program clients, cost of the program, achieving the objective of the program, etc.?
   - Should program parameters be varied to take into account sectoral, stage of business, type of project, etc., difference?
   - How does the fee structure of the program compare to the use of fees for similar commercial small business loans?
   - Should lenders be allowed to charge fees under the program which would be in addition to those presently designated by the federal government? If so, what

should the fees be, and what would be the potential impact of the imposition of fees?

- To what extent are personal guarantees being used by lenders for SBLA loans?

- What would be the impact on the program if lenders were not allowed to take personal guarantees?

3. *Do Differences in Financing Availability Exist Among the Provinces*

- Are there differences in the small business financing environment among provinces in Canada and between urban and rural areas? If so, should specific program parameters be adjusted accordingly? How would the program parameters be varied?

- What would be the impact of differentiating the identified program parameters on the basis of province and/or urban/rural location?

- Are there variations across the country in SBLA loan practices as applied by lenders?

4. *Extent of Program Awareness*

- Do borrowers recognize the SBLA program as a federal government program?

- What is the level of awareness of the program among the small business community by province? Are there differences in awareness by urban/rural location?

- How could program awareness be improved, and what would be the implications of any suggested course of action?

5. *Program Administration Considerations*

- Do lenders have any particular comments/concerns regarding the administration of the program, including areas such as registration, paper burden, claims processing, communication with the federal government adminstration, etc.?

- Should the SBLA program be linked to other activities of relevance to small business development (e.g., information services, counselling, etc.)?