SMALL BUSINESS FINANCING

AND

NON-BANK FINANCIAL INSTITUTIONS

Volume I: Text

A Study for the Small Business Financing Review

by

Facsym Research Limited

James V. Poapst
Project Director

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FOREWORD

Facsym Research Limited was formed to facilitate the undertaking by our faculty of major research projects with social purpose. It is fitting that our start-up project concerns the interests of the several hundred thousand independent Canadian firms that conduct business in our country.

In the Acknowledgement which follows, the Project Director, James V. Poapst, thanks the many persons who contributed to this study. It is my pleasure to endorse those thanks and to thank Professor Poapst for his own contributions.

D.J. Tigert
Dean, Faculty of Management Studies
University of Toronto
President of Facsym Research Limited

September, 1981

ACKNOWLEDGEMENTS

There are hundreds of persons to thank for their contributions to this study. Many we know; most we do not, having taken careful steps to preserve their anonymity.

There are the members of the Faculty of Management Studies, University of Toronto. George H. Haines, Jr, and Michael Berkowitz had the challenge of delineating small business. Daniel B. Thornton was responsible for the Survey of Small Business Managers, the largest single component of our study. Basil Kalymon's work provided the viewpoints of chief executive officers of financial corporations and trust companies, which structured some of our other work on the supply side of the market. Len Fertuck carried out the surveys of loan officers of financial corporations and trust companies, their financing files, and credit unions. Arrangements for including credit unions were not made until late in the project. Through Professor Fertuck's extra efforts we were able to include them in this report. Laurence Booth provided a foreign bank perspective on the Canadian market. Our conclusions and recommendations were the work of the four principal investigators, Professors Haines, Thornton, Fertuck and myself. In addition, Dan Greeno assisted in the preparation of the questionnaire for the survey of Small business Managers, Allan Paul provided statistical advice, and Warren Main reviewed the manuscript and prepared the executive summary. Joe D'Cruz was not able to join the study team, but provided informal liaison with the Small Business Financing Review.

André Raynauld, Université de Montréal, reviewed our manuscript. Woods Gordon Management Consultants were retained for the primary fieldwork on the Survey of Small Business Managers. Michael McClew, partner in charge of the assignment advanced our cause by arranging for the release of Clarkson Gordon audit staff to do the interviewing at a time of peak demand for auditing services. The fieldwork for the primary survey was coordinated by Barbara Wilkes of Woods Gordon. The market research firm of Thompson and Lightstone was retained to conduct the follow-up survey of non-respondents, under the direction of Frank Jacobson. Final data processing for the survey was done by Gerald Wisnoski of G.I.I. Information Systems Inc. Edward Hughes of Informetrica and James Whipp also helped with the statistical work.

Numerous requests were made of our sponsors. James Howe, Director, and Robert Teskey, Project Coordinator, Small Business Financing Review, James Scopic of RoyNat, Carne Bray of the Association of Canadian Financial Corporations, William Potter of the Canadian Association of Trust Companies, and Jonathan Guss of the Canadian Co-operative Credit Society responded to our queries and requests for assistance without compromising the objectivity of our work. James Howe in particular had the delicate task of orientating the research to the objectives of the Review while maintaining an arm's-length relationship with the study teams.

Some seventy chief executive officers, managers, and loan officers in the private sponsoring orgainizations and foreign bank affiliates gave time, information, and viewpoints. Federal and provincial regulators, and administrators of federal government programs were also interviewed by our faculty.

On behalf of the Canadian Co-operative Credit Society Joan Arnold compiled a digest of provincial law and related limitations on business lending by credit unions.

Research assistants were Gilles Bernier, who designed and conducted interviews for us in French, Anne Brown, Blair Currie, Graham Findlay, John Gerby, John H. Haines, John Hastings, Lew Johnson, Peter Jursevskis, Suzanne Poole, Charles Spencer, Jennifer Swan, and Katherine Walker.

Bonnie Rose-Elster had the difficult editorial assignment. She worked with diligence for many long days and numerous weekends to bring the study to fruition. Linda Palanica, principal secretary for the project, was aided by the secretarial staff of the Faculty of Management Studies.

Finally there are all the interviewees in the survey of Small Business Managers--300 respondents in the basic survey and 130 in the follow-up survey. By arrangement they are anonymous to us, but their responses are the primary basis for some of our most important conclusions.

James V. Poapst
Project Director

September, 1981

SMALL BUSINESS FINANCING AND NON-BANK FINANCIAL INSTITUTIONS

EXECUTIVE SUMMARY

by
O.W. Main

This study was commissioned by the Small Business Financing Review. It was co-sponsored by the Department of Industry, Trade and Commerce, RoyNat, the Association of Canadian Financial Corporations, the Canadian Trust Companies Association, and the Canadian Co-operative Credit Society.

The study has four objectives:

1) to identify key segments of small business (as distinct from large) to determine their distinctive needs for financing and related services;

2) to examine the current and potential availability of financing from non-bank financial institutions (NBFIs) in relation to the needs of small business;

3) to analyze the impact of government programs and instruments upon small business financing in light of current and potential activities of non-bank financial institutions and federal government objectives;

4) to make recommendations pertaining to public policy issues in light of the above.

Gaps in the Market

A gap is defined as a condition wherein some change can or should be made in the functioning of the market that will benefit the economy. In the capital market, it commonly means that there could be more funds and/or better terms for the borrowers.

On the supply side, gaps may occur because of regulations which prevent the market from operating efficiently. Four types of regulations are: interest rate ceilings, limit of terms of borrowing, borrower protection, and regulations excluding dealers from certain market segments.

Interest rate ceilings are now rare. Borrower protection regulations for small businesses, especially in the provincial domain, alter market activity, creating a gap if there is excessive withdrawal of lenders from the market. Limits on terms of borrowing under the federal Interest Act, which permits prepayment, make it difficult for unincorporated mortgage borrowers to borrow long term as the supply of funds is diverted to other markets. The regulation of lenders, especially those regulations relating to trust companies, limiting types of security and leverage, exclude them from markets which they could serve, and affect their supply price.

Other gaps might exist if risk aversion on the part of the lender raises the interest rate unduly or simply leads the lender to refuse to make the loan. Risk aversion premiums tend to be low as a result of diversification of investments, but would be somewhat lower if increased competition among the intermediaries were permitted.

The presence of differing interest rates for small and large borrowers may suggest a "gap" in the market. The differences which arise from the higher costs of administering smaller loans can be understood. However, the differences which arise from risk classification or from loans made on the security of assets with little resale value as opposed to assets with a known market, may lead to what the study refers to as attitudinal as distinct from real gaps. One cause of attitudinal gaps is differing perceptions of the riskiness of the loan between lender and borrower.

Major lending institutions need such a high level of expertise in assessing risk that they tend to operate in a limited range of risk classes. If other segments of the market do not pick up these risk classes, then real gaps may occur. As experience is accumulated, however, these gaps close. The key to closing real gaps is competition within and between the various segments of the market.

It has been suggested that small firms do not have access to public securities markets. However, the markets are not geared to the small amounts of equity financing that small business would need. In addition, the aversion of small business to dilute independence and control makes public equity markets irrelevant to small business.

Lengthy lender processing time may create a timing gap between the demand for and the supply of financing. This is a real gap which can be narrowed by experience on the lending side, and by more expertise by or available to the borrower so that he can present his needs and his plans in an organized manner.

Attitudinal gaps are viewed as arising from misperceptions of lenders' charges and anti-interest bias. Together with real gaps, they can be reduced by education of the borrower in good financial management or the provision of financial and general management services.

The View From the Demand Side

A special study of independent firms showed that 61% of them had sales below $100,000 and accounted for 4% of the market for all such firms in 1977/8. A sophisticated statistical technique was used to delineate small firms by industry (and to estimate in which industries there was meaningful entry into the large firm sector). In terms of 1977/8 sales, it was found that in 97% of the industries, the maximum sales for delineating small business was between $50,000 and $500,000.

An in-depth survey of a sample of 300 small businesses (as defined above) across the country revealed the following characteristics of the borrowing policies and practices of small businesses:

1) Small businesses went to chartered banks and shareholders for short term funds.
2) For long term funds, the banks were still preferred followed by shareholders, trust companies, financial corporations and the Federal Business Development Bank.
3) Credit Unions were used in areas where they were strong.
4) Equity capital came mainly from private shareholders, with the FBDB supplying a small amount. Venture capital firms were hardly used.

If the firms shopped, they shopped in the long term market. Little use was made of governmental agencies, and more use was made of the NFBIs if the borrower came several times to the market.

Most of the financial institutions received favourable ratings for their service. Seventy-five percent of small business borrowers reported that they always secured adequate financing. However, the firms had little interest in ancillary management services offered to them.

The firms that had financial managers valued their advice. Those who did not have them relied on ad hoc advice from banks and public accountants. The more financially informed the management, the less concern the firms had about finance and their ability to secure funds.

In general, financing rated well below marketing, production, personnel, inflation and cost controls as a problem area. It appears that governments are paying too much attention to a problem which is not regarded as serious.

The profile of the small businesses indicates that growth in sales, profitability and efficiency were the main objectives. Small business is not interested in sacrificing these objectives for more leisure time. The firms valued independence and were not very interested in outside sources of equity financing.

Government programs to aid small business were evidently not being used to the fullest extent. Small business was much more aware of federal programs than provincial ones, but almost half of the firms who were eligible never tried to use them. The main complaint was slowness, bureaucracy, and red tape which did not make the process worthwhile.

The main conclusion from the survey is that the markets seem to be functioning well. Firms with financially informed management were less likely to complain about interest rates and ability to secure funds. The low level of concern about financing as a problem indicates that government programs should place more emphasis on aid to improve the firms' abilities to handle the more important problems.

Financial Corporations and Trust Companies

The supply side of the market is as complicated as the demand side. In addition to many individual suppliers, there are many financial institutions which range in size, differ in organizational structure, and approach to lending. This study concentrates on the non-bank financial institutions of financial corporations, trust and mortgage companies, credit unions, and foreign bank affiliates. There are primarily involved in the market segment of long term debt. In total they account for 28% of the total assets of the selected financial intermediaries.

From the supply side of the market small business was viewed as firms with sales below $25,000,000.

These institutions are in the long term lending market, although some do short-term lending. They are interested in equipment loans and leases, and real estate leases and mortgages, and some general lending. Equipment lending is in the $100,000 range for highly standard type loans, and general lending above that amount. They are not interested in the lower end of the small business market or in high risk ventures.

Costs of processing loans are high because extensive documentation is required, including credit history, types of security, evidences of financial strength and business ability. The keys to the success of a loan are regarded as personnel, experience, well-defined plans and outlook of the firm. Interest rates range from 1 to 6 percentage points above the prime rate. Cash flow lending relies heavily on quality of management and past history of the firm.

Because the firms cannot, in general, take large risks, they lend mainly to firms in the rapid growth and maturity for firms in the inception stage, unless the firm has readily marketable equipment assets.

Financial Corporations do not regard regulations as being restrictive. However, the Trust Companies would like to see some restrictions eased in the "basket clause", with permission to take inventories as collateral, and more flexibility in percentage of capitalization to lending, and in high percentage of mortgages required in their portfolio.

Government programs were regarded as too slow and restrictive. Firms which make use of them were regarded as "at the bottom of the quality list" and of little interest to the lenders. The Small Business Development Bond Program was regarded as helpful but the limit on loans was considered to be too low.

All lenders stressed better business education as the key to a properly functioning market. They wished a redefinition of the role of government services to keep government institutions from competing with the private sector for loans which they could handle.

Credit Unions

The Credit Unions have a larger share of the small business market in the smaller centres, but it is not their main function, which is personal lending. Since they are community oriented, they do business in the local centres, lending to co-operatives, construction projects, income properties and business loans.

The type of borrower who would approach the credit union is primarily the small, young firms with no financial manager. The interest rates charged are usually prime rate plus 2%, with the same rate for all, based on their egalitarian philosophy. Generally, borrowers must be members so the market is limited.

The main problem for credit unions in small business financing is the high risk of default. Part of this is attributed to the lack of business expertise on the part of their borrowers, who are primarily at the smaller end of the market. Credit unions do not use the Small Business Loans Act because the paperwork is too demanding, and they do not use the Small Business Development Bond Program. As lenders, they feel limited in the type of security they can take. They would welcome a relaxation to permit them to take the same types of security as the Chartered Banks are allowed to take.

Foreign Bank Affiliates

Foreign bank affiliates have a very limited role, as yet, in small business financing. In the areas where they are suppliers, they have an advantage in international trade financing. However, they are also active in the short term demand credit, 5 year term loans for inventory financing, and in long term equipment finance and leasing.

There are basically two types of lenders -- asset-based and general lending. The asset-based lender relied on specific collateral and tailored their loans to compensate for risk by changing interest rates, terms of lending and amount of collateral required. The general term lender operated at the top end of the small business market where interest rates were non-negotiable and the market intensely competitive. To succeed in both markets, the foreign bank affiliates actively sought business, competing in the asset-based market by devising special loan packages and in the general term lending market, by their advantages in international exposure.

The spreads between the cost of funds and the rates charged varied with the size of loan and the risk involved. It was the opinion of the managers that the fixed cost of making a loan restricted their interest in small business financing to the larger end of the market. It was felt that in the lower end of the market where they competed, that interest rates were not as important as the terms and conditions of the loan.

Generally, the foreign bank affiliates do not feel that their current operations are significantly affected by regulations or small business incentive programs. They showed little interest in incentive programs because the time and paperwork required to get reimbursed did not make lending in that area worthwhile.

Comments on the state of small business financing revealed two definite opinions. The first was that the chartered banks were too conservative and too rigid in their lending policies. The second was that small business financing was not a loan problem but a management problem. Small businesses, especially at the inception stage, lack sufficient equity and good management to make them good borrowers.

Government programs were viewed as comprehensive, but the implementation of the programs left much to be desired. The FBDB was thought to be too slow and too officious and grant programs were too often open to abuse from firms that did not need them. Overall, the red tape and slowness of decision making in the government programs prevented them from fulfilling their proper social role.

Impact of Government Regulations

Provincial legislation affecting small business is primarily designed to protect the borrower. It includes setting priorities for claimants, prohibition of chattel collection under some circumstances, and realizing on collateral. In Quebec, protection of the unincorporated businesses has closed off this market, at least for the non-bank financial institutions included in this study. In Nova Scotia and New Brunswick, the lack of central registries increases the cost of making loans on real assets.

The Federal Interest Act which permits the unincorporated borrower to prepay his mortgage loan makes it difficult for the lender in the long term market, which in turn tends to limit the term of mortgage loans to five years. This may be too short a time to cover the borrower's needs.

Financial Corporations are regulated, but this does not affect their activities in small business lending.

Trust Companies are only marginally in small business lending, but they are showing more interest in the area. The chief regulatory limitations on them are limits in leverage the prohibition of using current assets as security.

Credit Unions are regulated by the provinces and by their own regulations. In some provinces, the types of businesses which may become members are designated. Local lending is usually guided by the central bodies in terms of loan limits and type of security, as well as a limitation on the portfolio of business loans to some minority share assets.

Conclusions

Financing is a less important problem to small businesses than other management problems. If financing is a problem it is likely to be that the firm has no full-time financial manager and has no expertise in the area.

The areas for entry and growth of small firms seem to be limited to service and retailing. The typical small business is very small and their main needs for financing are for equity captial. Since they prize independence, they do not share equity and they use term financing more often than other forms. Term financing is most easily obtained where the assets have active resale markets; less so where the assets do not have a ready resale value.

Although the type of business does not normally affect where the businesses seek financing, the exception is in the manufacturing sector. Manufacturers seek financing from financial corporations which have the expertise to assess the risks. Smaller manufacturers are more likely to seek long term financing from FBDB.

The availability of financing seems to be adequate from the viewpoint of small business. The major source of supply is the chartered banks, but non-bank institutions are viewed as a source of term financing (including leasing). In this area, the companies are competitors of the chartered banks. However, since the chartered banks have a competitive advantage, they are regarded as being too conservative. The non-bank institutions are more competitive and fill in segments of the market where special expertise is required.

Interest rates are the main concern of borrowers, but the requirements for personal guarantees and collateral are important. The interest rate does not comprise the full cost of lending. Fees may be charged if they are not included in the interest rate, since the fixed cost of processing a loan is about the same regardless of the size of the loan.

Small business financing by non-bank institutions can be increased by relaxation of some regulations and by the development of more staff trained in small business lending.

Government agencies appear to be under-utilized, and they are regarded as bureaucratic and slow. FBDB is used mainly by small firms without full time financial managers. The more financially informed small firms prefer the private sector, and see less need for government intervention.

Higher interest rates for small businesses are not evidence of a gap to be filled by government intervention. There is no strong evidence that government financing programs are needed. The existence of such programs perhaps makes it easier for private suppliers of capital to reject low quality applications. These low quality applicants suffer from poor management and programs designed to improve their management abilities would do more than low interest rates to improve their chances of success.

Concentration of government efforts to aid small business should be on management education, including financial management education, rather than upon the provision of financing which can be handled well by the private sector.

Recommendations

Small businesses do not appear to view financing as a leading problem. Governments therefore should direct their resources to assist small business in problem areas as viewed by small business itself. The programs devised should be geared to a proper definition of small, which differs from industry to industry.

The Interest Act should be amended to permit unincorporated business mortgage borrowers to trade off prepayment privileges after five years for more favourable terms.

The Federal Trust Companies Act should be amended to permit more freedom for the Trust Companies in making business loans.

The basis for providing security under section 178 of the Bank Act should be made available to other lenders.

The FBDB program to develop managerial skills should be retained and developed. There may well be a continuing role for the financial services of FBDB in strategic term lending, equity financing, and in activities in remote communities not served by other institutions. The more general lending operations of the Bank should be studied to determine what is best to do with them.

Chapter 1

SETTING THE STAGE

by
James V. Poapst

Small business financing is a government policy area where economic considerations and social attitudes may or may not agree. Conflicts arise and important issues emerge which require resolution. In the past unfortunately, issues have been decided on the basis of little objective information and analysis. There has been little research in the area. Recently the federal government took steps to change this condition. This study is one of several prepared as part of the federal government's Small Business Financing Review.

Our assignment included projects about both the demand and supply sides of the market in small business financing. On the demand side the study delineates small business and analyzes its financing policies, practices and problems. Short- and long-term loans, long term leasing, and equity financing are included. On the supply side of the market the focus is narrower - small business financing by certain types of private non-bank financial institutions (NBFIs). Included are Roynat, financial corporations, trust companies, foreign bank affiliates, and credit unions. These institutions provide various types of term financing, some short-term loans, and negligible equity financing. Short-term lending and equity financing (and taxation) are examined in other studies prepared for the Small Business Financing Review.

Objectives

Specifically the study has four objectives:

1) to identify key segments of small business (as distinct from large) to determine their distinctive needs for financing and related financial services;

2) to examine the current and potential availability of financing from non bank financial institutions in relation to the needs of small business;

3) to analyze the impact of government programs and instruments upon small business financing in the light of current and potential activities of non-bank financial institutions and federal government objectives;

4) to make recommendations pertaining to public policy issues in light of the above.

Market Segments

The market in small business financing has several parts and multitudes of participants. There are markets in sole proprietorships, partnerships, corporate common and preferred equities, long-term loans and leases, and short-term loans, leases and trade credit. There are several hundred thousand small, independent businesses that require financing. They are spread over many industries, at different stages of development, located at many points across the land, with differing levels of quality of management. Similarly there are hundreds of thousands of suppliers of financing to small business, including financial institutions, individuals, and trade creditors. The institutions are of several types, range in size from very large to very small, differ in organizational structure, and approach to investment. Some are generalists and some are specialists. Individuals are large in number and are important as buyers, holders, and sellers of equities in small businesses. As holders of such equities they are often owner-managers and single-equity investors. Trade-creditors are numerous, but specialists.

There are several bases on which this market can be segmented. Type of financial instrument is obviously one. To both demander and supplier it means terms and conditions, and also for the supplier whether it is a type he provides. Industry is a second basis for segmentation. It implies types of assets to be financed, and risk and collateral value for the lender. Growth rate of the business is another basis. It affects the amount of financing required, the demands made upon management, risk, and future business opportunities for the suppliers. Growth rate together with age of firm can serve as a proxy for stage in the firm's life cycle: start-up, rapid growth, decelerating expansion, stability, decline, termination. A fourth basis of segmentation is location of the firm. Number of suppliers tends to be correlated with size of community. Also distance from suppliers affects costs of financing. Then, there is risk. As already indicated it is associated with other bases of segmentation. But it is sufficiently important to be enumerated separately. Both demanders and suppliers are interested in risk levels in themselves. Among a borrower's concerns is how the lender will deal with him in the event of default.

These five segmentation variables - instrument, industry, growth rate/life cycle stage, location, and risk class - are pertinent to both small businesses and their suppliers of finance. The variables are also relevant to public policy makers.

As found in this study, there is another segmentation variable that is important in the market for small business financing. It is whether or not the firm has a full time financial manager. Firms that do, tend to have very different experiences in the market from those who do not.

Market segments are discernable in terms of combinations of the above variables - e.g. debt financing for start-ups in driveway paving. Market segments, however, do not exist in isolation. There are several linkages between them. There is some range over which firms can substitute one means of financing for another. Major financial institutions offer more than one type of financing to firms in many industries, at more than one stage in their life cycle, at numerous locations, and in more than one or two risk classes. Many financial institutions are more specialized. They may concentrate on one type of financing for one type of asset, e.g. automobiles. Private investors are commonly interested only in equity investments. Nevertheless, shifts in demand and supply between market segments can be expected to elicit responses in the flows of funds.

A Central Question

A central question faced by the Small Business Financing Review is whether there are important gaps in the financial markets that affect the flow of funds to "small" businesses. Popular conventional wisdom holds that there are. Gaps may be thought of as occurring at two levels. One is where there is a demand for funds for which there is no supply because of some structural impediment on the supply side of the market. This would be an extreme case. At a lower and more realistic level, gaps are alleged to exist because the amount offered, interest rate, term and amortization period, collateral requirements, covenants are one or severally "unreasonable," where "unreasonable" means that there is unjustifiably little competition between lenders.

Should such gaps exist, they could restrain economic development by restricting the supply of funds to economically relevant firms during the rapid growth stage of their life cycle. They could also make smaller firms vulnerable to takeover and thereby increase corporate concentration or foreign ownership.

Terms of financing may also be called "unreasonable" when competition is high but there is a popular belief among borrowers or their spokesmen that terms could or should be easier. In this case, there is a social or attitudinal gap rather than economic gap.

Attitudinal gaps pose a different problem. They are an obvious challenge for the politician. Catering to them appeals to entrepreneurs who want lower costs and to those who believe that small business has special economic and social roles to play. On the other hand, such gaps may lead to measures which misallocate resources from an economic standpoint. Subsidized credit may sound a siren call to would-be-entrepreneurs, but result in too much economic damage in relation to the successes achieved. Presumably research has a role to play in relation to both economic and attitudinal gaps.

Demand Gaps

The gaps referred to in the popular conventional wisdom are supply gaps. There is another type of gap to consider, those on the demand side of the market in small business financing. As with supply gaps, demand gaps can be viewed at two levels. At one level a gap exists whenever a business arbitrarily restricts its external financing to an amount that is less than it could profitably use to finance capital investment. Such self-imposed capital rationing can stem from a number of causes. For example, a successful businessman may have profitable investment opportunities to exploit, but may not wish to endure the change in managerial style required if they are to be undertaken. He may prefer to delay expansion until he convinces a successor of their reality at which time he will realize a capital gain on selling out. But whatever the cause, demand gaps at least mean postponing profitable investment opportunities, and these opportunities are not invariably picked up elsewhere in the domestic economy. Economic growth and development may suffer.

At the second and less extreme level, the business may seek financing for all its possible projects, but do so inefficiently. As a result financing is more expensive than it could be and some projects might be dropped because they are unprofitable or cannot be financed.

Our study emphasizes supply gaps in the market for small business financing, but extends to demand gaps.

Approach and Content

Supply and demand gaps are difficult to measure with any degree of precision. Fortunately, it is not necessary to do so to provide information useful for public policy purposes. By examining the demand and supply sides of the market in small business financing, we can ascertain the nature of such gaps as may exist, and provide inferential evidence about them. At the very least, by increasing our understanding of the functioning of this component of the capital market, we can provide a basis for reducing attitudinal gaps. In so doing, economic policy making becomes less encumbered. The concept of a "financing gap" is somewhat nebulous. The first step in the study, therefore, is to elaborate and clarify the concept.

The next step is to obtain a clearer empirical picture of small business in Canada. In past studies arbitrary, universal definitions have been used to delineate small business -- e.g. asset size, sales size, market share, number of employees. These were used without sufficient consideration of their analytical relevance. A business has many attributes and so can be small in many ways. The way(s) to be highlighted depend(s) upon the purpose(s) of the study. Our study examines the sales distributions of firms for a large number of individual industry classes and sub-classes (i.e. at the 3 digit SIC level) to develop an industry-variable indicator of "small business." The approach used assumes that a primary policy interest in small business lies in its ability to compete with large firms in the same industry.

Another approach to delineating small business is relevant in a study of financing. That is to view "small" in terms of supply of financing considerations alone. This highlights the importance of fixed and variable costs as they relate to the amount of financing supplied. The division of costs varies between capital market sectors. Thus a small public utility, for example, might be large enough to make public offerings of securities where a large restaurant could not.

Financing costs of course are affected by risk. To the extent that risk correlates with size of business, independently of industry and other influences, the difference between the two views of "small" lessens. Nevertheless, it is necessary to keep clear the distinction between "small" defined in terms of total costs and "small" defined in terms of financing costs only. The latter basis was used in our work on the supply side of the market, which was initiated before the work on the demand side. For the supply side, sales up to $25 million for an independent firm was used to define small.

Our second project on the demand side of the market is the survey of small business financial managers. It is an interview survey of 300 small businesses. It is concentrated in 10 metropolitan areas and major urban centres in eight provinces. The firms were selected on a stratified, random, sequential basis from the Dun and Bradstreet population for the 10 centres, with upper size limits varied by industry in accordance with industry-variable estimates of small. The survey seeks information on several topics. Included are company characteristics, the financial manager, current financial policy, financial search sequences, financing experience, future financing intentions, government assistance, and the objectives of the business and the importance of financial and other problems.

On the supply side of the market, to provide an overview of their overall activities, strategies, and assessments of prospects chief executive officers of RoyNat and selected financial corporations and trust companies were interviewed. Also conducted was an interview survey of loan officers of selected NBFIs. This survey is designed to cover the two main types of long term creditor financing to small business, so-called "formula" lending and so-called "term" lending. The former relies heavily on collateral value, the latter upon the credit standing of the borrower. Insofar as feasible, one condition in selecting loan officers was that they were involved in lending or leasing in the localities of the survey of small businesses.

Another component of the study is a survey of Applications for Financing. This survey supplies actual terms and conditions of financing and financing characteristics of applicants. Recent applications accepted by financial corporations and trust companies are included. Again, insofar as feasible, the survey is for applications in the localities of the survey of small businesses.

Some credit unions and caisses populaires make loans to small business. Most credit unions and some caisses populaires in provinces other than Quebec are affiliated through provincial centrals which in turn are shareholders in a central-central, the Canadian Cooperative Credit Society (CCCS). An interview survey was conducted on small business financing by selected members of this three-tier system. Executives in individual credit unions, provincial centrals and CCCS were included.

As they were constituted until recently or still are, many Canadian affiliates of foreign banks fit into the category of NBFIs. Because of the impending developments under the new Bank Act, the category of many of these lenders is subject to change. However, because of their numbers, it as considered desirable not to omit them completely from the study. Accordingly, six were interviewed.

Finally, government regulation of lending and our three types of NBFI lenders are reviewed for impacts on the market in small business financing. Provincial government legislation on borrower protection provides certain bedrock conditions that lenders must meet and affects minimum terms and conditions that can be offered to borrowers. Similarly legislation governing NBFI operations affects their abilities to finance small businesses. As a contrast to the circumstances of private lenders, recent operations of the Federal Business Development Bank (FBDB), the largest public lender to small business, are reviewed. Also some comments are included on the Small Business Loans Act. There is limited reference to the numerous provincial agencies which provide financial assistance to small business. They are viewed as largely beyond the scope of the study.

Table 1-1 indicates the size of the suppliers included in our study. The table shows the total assets for 10 types of debt-oriented private lending institutions, and the Federal Business Development Bank. Mortgage corporations affiliated with chartered banks and the segregated funds of life insurers are counted separately. Trust companies and mortgage loan companies are combined because of the importance of the ownership links between some of them. Financial corporations, trust and mortgage loan companies, credit unions, and foreign bank affiliates had assets outstanding of $107 billion at end of 1980. This was 28% of the total assets of the 10 types of intermediaries. RoyNat and other financial corporations devote a high proportion of their assets to business financing, including small business. For trust and mortgage loan companies, credit unions, and foreign bank affiliates, the proportion of assets in small business financing is much lower.

Banks and their associated mortgage companies accounted for nearly one-half the total assets of the 10 types of institutions. Of non-bank financial institutions, those featured in this study accounted for more than one-half of the total assets. The combined assets of the three types of institutions were about 50 times that of the Federal Business Development Bank. The latter, of course, devotes a substantial proportion of its assets to small business financing.

The study is divided into ten chapters and six appendices. Chapters 2 to 9 and Volume II, Appendix A present the material outlined above. In light of the findings of the study, Chapter 10 sets out our conclusions and recommendations. The more technical material is in the appendices.

Table 1-1

Total Assets of Selected Financial Intermediaries, End of 1980

	$ Billion	**Total**	**Non-Bank**
Chartered banks[a]	171	44	-
- associated mortgage companies[b]	9	2	-
Financial corporations	14	4	7
Trust and mortgage loan companies[c]	55	14	27
Credit unions[d]	35	9	17
Foreign bank affiliates	3	1	1
Financial leasing companies	2	1	1
Life insurers[e]	40	10	20
- segregated funds	7	2	3
Trusteed pension funds	51	13	25
Total	**387**	**100**	**100**
Federal Business Development Bank	2	1	1

a Canadian dollar assets.
b Total major assets.
c Company and guaranteed funds only.
d Total assets of locals and centrals, less liabilities of centrals to locals.
e Total assets less liabilities held for business out of Canada.

Sources: Bank of Canada Review, July, 1981; Statistics Canada, Financial Institutions: Financial Statistics, First Quarter, 1981; Statistics Canada, Quarterly Estimates of Trusteed Pension Funds, First Quarter, 1981.

Chapter 2

FINANCING GAPS

by
James V. Poapst

Meaning of Gap

For the purposes of this study, gap is defined as a condition wherein some change can or should be made in the functioning of the market for goods and services that will benefit the economy through its favourable impact on consumers. In a capital market, the focus is on the volume of funds and terms of financing, especially the interest rate, available to borrowers. A gap commonly means there could be more funds and/or better terms for borrowers. This study focusses on financing gaps.

It is useful to explore the subject of financing gaps at two levels. The first is through basic economic analysis. What can such analysis tell us about the existence and consequences of gaps in the market in small business financing? Clarification of the concept of a gap in economic terms is important for public policymaking. The second level of exploration is that of popular values, or "attitudinal gaps." Small business financing is a politically sensitive subject and public policymakers are ultimately accountable to the public. So we review attitudinal gaps about financing under two sub-headings (1) misperceptions about lenders' charges and (2) antipathy to interest itself. The implication of such beliefs is that the supply curve for small business financing should be lower than it is.

There is another type of argument for lowering the supply curve for small business financing. It is the subsidy argument. It is predicated on the roles that small business is viewed as playing in the economic system. These are noted in the last section of this Chapter. This section includes a brief discussion of gaps in the demand for financing, i.e. possibilities for improving the market in small business financing from the demand side.

For broader studies a broader consideration of gaps would be appropriate. Our approach includes both attitudinal supply gaps and demand side gaps in the market for small business financing. It does not include other sources of distortion in the activities of small business, and deals little with subsidized financing as a means of addressing them. The traditional concern of policymakers with institutions such as FBDB, we submit, has been with financing gaps as defined above.

Economic Supply Gaps

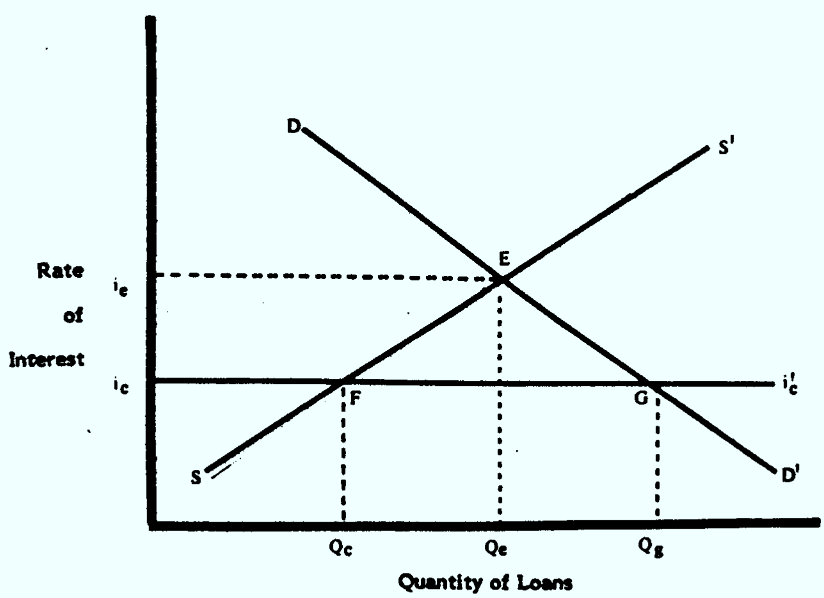
Regulation

(i) Interest rate ceiling

Such ceilings are now rare. They are more important for their potential use than for their current use. Also they provide the simplest illustration of the concept of a gap. Consider the case of a ceiling on the interest rate for government insured loans (to small business). Assume that the insurance makes the loans riskless to lenders. The case is illustrated in Figure 2-1. DD' and SS' are free market demand and supply schedules for the risk free loan. Q_e and i_e are the market equilibrium quantity of funds transacted and the interest rate. The interest rate ceiling $i_c i'_c$ is below i_e. Measured in relation to equilibrium, the interest rate gap is $(i_e i_c)$. At interest rate i_c, transactions amount to Q_c and the quantity gap is $(Q_g - Q_c)$.

Figure 2-1

FINANCING GAP CAUSED BY INTEREST RATE CEILING



As a result of the price ceiling being below the equilibrium rate, interest rate and activity are below free market levels. At Q_c, value equal to (i_e-i_c) Q_c, which at the free market rate would accrue to lenders, accrues to borrowers. The reduction in borrowing (Q_e-Q_c) has associated with it some cost in value of economic output. What this value is, entails a further question: Who gets the funds Q_c? Leaving aside the consideration of repeat lending and assuming the insurance includes all opportunity costs associated with realizing on claims, lenders would be indifferent about which projects are accepted. In reality, existing lender-borrower relationships and other considerations affecting future business would influence the selection.

(ii) Limit on Term of Borrowing

The federal Interest Act (R.S.C., 1970, Chap 1-18) does not impose ceilings on market interest rates. However, it does provide unincorporated borrowers a minimum prepayment right for mortgage loans on real estate. Any such loan may be paid off in full after it has been outstanding for five years, irrespective of the term for which it is written. The lender may charge a penalty of three month's interest on the prepaid amount. This law makes it difficult for unincorporated borrowers to obtain real estate mortgage loans for a term beyond five years, especially during periods of widely fluctuating interest rates. If a loan were written for 10 years and interest rates fell sufficiently after five years, borrowers could prepay. If on the other hand rates rose, borrowers would let the loans run to maturity. Lenders thus would find it difficult to match the duration of their assets and liabilities. To the extent that they wish to do so, the Act encourages them to turn to finance other types of borrowing, thus creating a gap.

(iii) Borrower protection - provincial regulation

Small business financing is also subject to various provincial statutory measures which are directed to strengthening the position of the unincorporated borrower relative to the lender. Consumer protection legislation sometimes extends to unincorporated business borrowers, most notably in Quebec. Other provincial legislation is directed to protecting borrowers in default.

Such legislation might be expected to change interest rates and transactions volumes, compared to those that would otherwise prevail. Conditions imposed on lenders that required some of them to change their operations presumably raise lending costs, thereby raising the supply curve.[1] Simultaneously, by reducing risks for borrowers the demand curve is shifted to the right. Interest rates, therefore, would rise, at least temporarily, for two reasons. Transactions volumes would change, increasing or decreasing depending upon the relative magnitudes of the shifts in the supply and demand schedules and their relative elasticities.

The existence of gaps attributable to borrower protection legislation depends upon opportunities to improve financing for borrowers. The basis

1 **There is also a possibility that the supply curve could fall. See Chapter 9.**

for comparison is not only other regulations, but what lenders would do in the absence of certain regulations. Where free to do so, lenders can be expected to regulate their own activities in keeping with their perceptions of their own best interests. As in markets for other products customer satisfaction is important. An absence of government regulation does not mean lender tyranny.

It appears from the interviews that there can be a supply gap for unincorporated borrowers in Quebec because of the terms of its Consumer Protection Act (See Chapter 9). There are smaller problems from corresponding legislation in other provinces. In the other area of borrower protection, protection in default, the perception of gaps is more difficult. Changing the level of borrower protection in default affects both the level of financing costs and its division among borrowers (see Chapter 9). The question of gaps gets confounded with the question of equitable distribution of costs.

(iv) Regulation of lenders

Regulations that exclude lenders from particular product/market segments can readily create gaps. Again of course, the gap is created to the extent that the lenders would otherwise participate in the product/market segment and borrowers would benefit thereby. Perhaps the greatest gap of this kind for small business financing was the longstanding prohibition of banks from conventional mortgage lending, which was removed in 1967. A gap of current interest is the prohibition of federally registered trust companies from making loans secured primarily by current assets (see Chapter 8). Also, these trust companies believe that if the levels of leverage at which they are allowed to operate were higher, their cost of capital would be lower and they could compete more effectively with banks. In effect, they believe a regulatory gap exists.

Risk Aversion

To enjoy the same expected return as for investing in "riskless" government insured loans, lenders must include a premium in the loan rate to allow for losses. If investors were risk-neutral and the required premium were correctly estimated, the risky loans would be equal in attractiveness to the "riskless" loans. But most investors are risk averse, including those who finance lending institutions; they require a premium for bearing risks. The nominal interest rate must include a second premium - to compensate for risk bearing.

In terms of Figure 2-1, SS' would be the supply curve for risk neutral investors. It would be higher than in the risk free case to allow for the losses that will occur in the absence of lender insurance. Adding the second premium for risk aversion would raise SS' above its risk neutral level. DD' would remain as before in that borrowers were not insured. Risk aversion causes higher interest rates and lower transactions quantities compared to risk neutral lending.

Risk aversion premiums in themselves are not indications of financing gaps; they are simply part of the human condition. However, one of the roles of financial institutions is to reduce the size of risk aversion premiums through diversification of investments. Gaps exist only if increased competition among the various types of financial intermediaries could be sustained and would improve terms of financing for small business borrowers.

Loan Size, Risk and Accumulation of Experience

Lending institutions commonly divide their loans into classes with similar characteristics. One characteristic is the expected loss rate. As large numbers of similar loans accumulate, the loss rate tends to become more stable and predictable under given economic conditions. This is the result of diversification of the risks that are specific to the individual loan, such as the character of the borrower. Loan classes could thus be ranked on the basis of their expected loss rate, e.g. low, medium and high. Because some administrative costs of lending are fixed, small loans require higher administrative costs per dollar than medium and large-sized loans. This difference increases with level of risk. The more risk, the more appraisal required. The effect diminishes on repeat business as borrower experience and lender knowledge of the borrower accumulate.

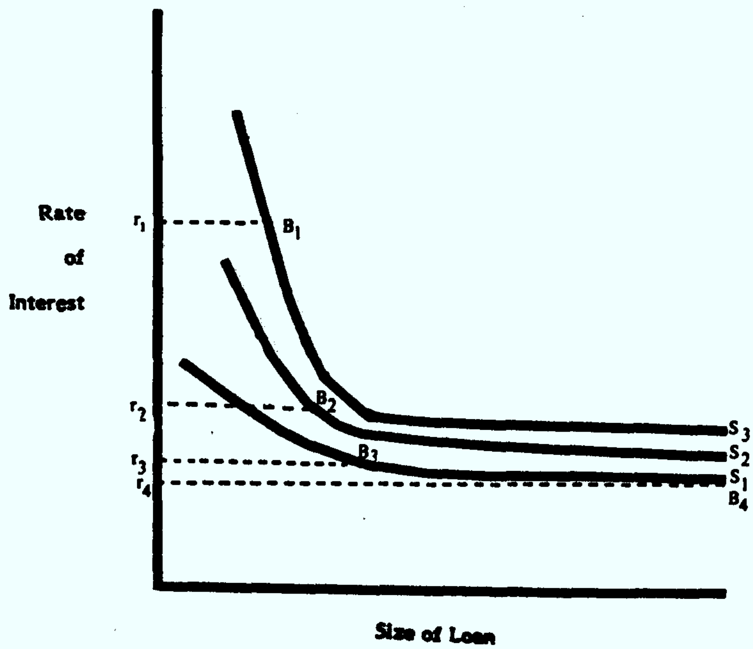
These conditions combine to produce differences in interest rates charged to small and large borrowers, as illustrated in Figure 2-2. S_1, S_2 and S_3 express the relationship between interest rate and size of loan for three levels of risk in increasing order. The downward slope of the curves reflects fixed costs of administration per dollar of loan, and the increased significance of such costs with risk - i.e. the decline in S_3 S_2 S_1. B_4 represents a well established borrower of low risk who borrows a medium or large amount. B_1 represents a new firm of high risk, which borrows a small amount. B_2 reflects the effects of reduction of risk through accumulation of management experience by the borrower, the establishment of a track record which provides knowable information for the lender and growth in the business which leads to borrowing greater amounts. B_3 represents a small borrower who is viewed as being no more risky than a large borrower. The fact that many small firms are in a position akin to B_1 and B_2 and medium and large firms are in a position akin to B_4 does not in itself indicate that an economic gap exists. If there is in fact a high standard of competition in all risk classes, we would say that no gap exists.

Alternatively B_1 and B_2 could both be viewed as new firms, but B_1's fixed assets are not readily marketable whereas B_2's are. Lending to high risk borrowers requires specialized knowledge. Where not enough is knowable about the borrower, reliance must be placed upon the collateral. Knowledge about its resale market is critical. Where assets have no perceptible net value on resale, so-called "single-asset lenders" cannot operate. There is some tendency to refer to the absence of lending in such situations as a "gap" in the market, with the implication that it should not exist. This is analogous to referring to the absence of a large, heavy, high powered automobile that gets 100 kilometres per litre as a gap in the car market. It is simply beyond current technological capability to produce it on an economical basis. So too with loan financing for "unknowable" applicants with non-marketable assets.

Assuming reasonably high standards of competition between lenders, there is not an economic gap in the situation depicted in Figure 2-2. There may well be an attitudinal gap, however, which is worth noting at this point. Suppose that the risk classification of the borrower by the lender is not consistent with the borrower's self-classification. If a borrower allocated to risk class S_2 by the lender believes he should be in risk class S_1, he will consider himself to be overcharged. Even as a process of approximation, there can be errors in administering lending procedure. But more important, most borrowers in all moderate risk classes, do in fact repay in full. Those who felt overcharged and who repay in full naturally may regard their performance as confirmation of their original belief. Thus we can have a situation in which lending is competitive, loan officers are doing their best at risk classification and there is an attitude among borrowers that a financing gap exists in the sense that charges are too high. To argue that this is an economic gap is to impose a standard beyond the current state of the art of risk analysis, assuming reasonably high standards of competition.

FIGURE 2-2

RATE OF INTEREST vs. SIZE OF LOAN
MULTIPLE RISK CLASSES



Risk Class Specialization

To make their operations more efficient lending institutions organize their activities to serve selected market segments. In so doing, lending is confined to a limited range of risk classes. Loan officer training and experience equips them to appraise a limited variety of risks. Also, while branch systems provide opportunities for considerable diversification at the corporate level, internal reward systems may inhibit risk taking over the whole range that is attractive at the corporate level. A single loan officer's approvals are simply less diversified than the total for the corporation. Unless performance appraisal systems can adjust for this, loan officers may well be cautious about loan applications in the corporation's top risk class. In the imprecise world of risk analysis, lending institutions must be concerned with the signalling effects of interest rates. Beyond a point, high asking rates may have an adverse sorting effect upon loan applicants. (Stiglitz and Weiss) High interest rates might elicit a disproportionate number of high risk applicants. "They are willing to borrow at high interest rates because they perceive their probability of repaying the loan to be low."(Stiglitz and Weiss, p. 393) Where differences are sufficiently observable and the appropriate applications rejected, sorting costs are increased. Where differences are not sufficiently observable and applications are accepted, losses may increase disproportionately. Also, it can be shown, theoretically, "that higher interest rates induce firms to undertake projects with lower probabilities of success, but higher payoffs when successful." (Stiglitz and Weiss, p. 393) Altogether, there are potent reasons for individual lending institutions to operate over a limited range of risk classes. Coverage of borrowers' demands in a high range of risks classes therefore requires a variety of lending institutions collectively able to operate over the whole spectrum of risks that is amenable to debt and lease financing. Competition comes from the numbers of lenders of each type and partial overlapping of ranges of risk classes served.

In their lending operations, banks have emphasized medium and large sized loans which tend to be in medium and low risk classes. Because of this and the banks' enormous size, the impression may be created that there exists a gap in higher risk classes. There are other financial institutions, however, which are organized to serve market segments characterized by greater risk. Specialized investment or financial corporations and leasing companies undoubtedly would be willing to expand their activities if demand permitted.

Stirring changes are occurring in the financial system that should affect small business financing. The new Bank Act is designed to encourage competition in banking by admitting foreign banks and facilitating the formation of new domestic banks. (Where new foreign banks formerly operated as NBFIs some changes will be small.) Increased competition for medium and large business accounts would increase interest in smaller accounts. Credit union interest in small business financing is increasing, one reason being the appeal of better matching of interest rates.

Transitional Gaps

As industrial processes change and new types of fixed assets come into use, there may be a period of time during which debt financing for them is not readily available. Lenders are unsure of the new industrial processes and a resale market in the new types of assets is not sufficiently established to meet lenders' needs. As time passes and demand grows, some specialized lenders enter the field. The initial entrants are able to obtain higher than normal profits until sufficient lenders enter the field to create a high standard of competiton. For a time, there is a "gap" in the capital market segment and successful innovators reap extra rewards. The gap is not serious; it merely reflects the operation of the price-profit mechanism on which the dynamism of the market system is predicated.

Lack of Access to Public Securities Markets

It is sometimes said that small businesses are at a disadvantage in financing, relative to large ones, because small businesses do not have access to the public securities markets. This contention needs to be qualified. The basic reason for small firms not having access to the public securities markets is that they do not need it. The need for such access is linked to there being a benefit in being able to divide the financing into many component parts that exceeds the costs of doing so. The benefit arises when the amount of financing sought is sufficiently large that there are few investors who would supply the entire sum. A high price would be required to induce one of them to do so. Being able to divide the financing enhances competition among suppliers and eases the terms of financing obtainable. Viewed in this way access to the public securities markets avoids a disadvantage to the large firm.

Lender Processing Time

At the start of the chapter, it was stated that a gap commonly means that financing could be provided on better terms for borrowers. Terms for borrowers are not restricted to those expressed in the contract. Costs which are not part of the contract itself may outweigh some fraction of the costs imposed in the contract. Lender processing time is a case in point. The borrower's circumstances may make it more important to obtain funds quickly than to obtain the lowest interest rate available if to do so involves considerable delay in obtaining financing. Viewed in this way, a lengthy approval process to obtain funds "on reasonable terms and conditions" may in itself constitute a financing gap. Financial management is concerned with paying bills as they fall due and being able to finance profit making opportunities as they arise, as well as with optimizing financing costs.

Caveats on Supply Gaps

The review thus far makes two main points. First, there are bound to be some supply gaps in the debt market in small business financing, but it is not obvious that they are very serious. Government regulation accounts for some gaps and it can be changed. Second, there are conditions which on the surface might suggest that supply gaps exist, but which are also consistent with the absence of gaps. Before turning to the subject of attitudinal gaps, however, two caveats to the previous discussion need to be noted.

One concerns financing in which the process of appraising the application is time consuming and otherwise costly. As negotiations proceed with a particular supplier, the latter accumulates information necessary to decide on the loan. In the process, the applicant's bargaining position declines unless all the information accumulated is freely transferrable to another supplier. To the extent that it is not, the applicant would have to start the process again, if he breaks off negotiations. Also, as time passes, the applicant's need for the financing may increase more than the lender's need for the specific loan. As a result, market segments characterized by high transactions costs could be less competitive than the number of suppliers suggests.

High transactions costs per dollar of financing occur in venture capital markets for small firms which devote minimal time to financial management and are in the start up or early expansion stage. Although transactions costs may be lower, the situation may also occur with similar applicants in high risk debt markets. The key consideration is how much information is transferable by the applicant to another lender.

The second caveat is a question about loan portfolio management. How far do lenders push the matter of diversification? Earlier, it was stated that loans were divided into risk classes based on their expected loss rate. With numerous loans in each risk class, there is diversification of risks within the classes which tends to reduce fluctuations in loss rates for each class. But loss rates do vary, which raises a further question. How do the variations in loss rates for a risk class move in relation to variations in the loss rate for the lender's portfolio as a whole? Suppose that the covariation between loss rates for some high risk class and for the portfolio as a whole is low, say zero or slightly negative, while the covariation for some low risk class is high. Then the pattern of movement of losses in the high risk class would have a greater impact on reducing variations in the loss rate on the total portfolio than would variations in the loss rate of the low risk class. Loans in the high risk class then, would have a special attraction. If this attraction were generally known among lenders and they responded by competing more actively for "low covariance loans," the interest rates on such loans would be bid down somewhat compared to the level based on expected loss rate alone.

We are not aware that covariance considerations are explicitly included in loan portfolio management practice. Perhaps it would not be possible to implement them. Perhaps they are incorporated to some extent implicitly. But if there is knowledge of covariances and they are sufficient to have a significant practical impact, not incorporating them in loan pricing would mean that gaps exist. It would also mean that loan rates are too low in some risk classes.

Attitudinal Gaps

With attitudinal gaps, the focus of attention usually is the relocation of the supply schedule below its existing level. Interest rates charged to small business should be less than they are and by extension, larger supplies of funds should be available at a given rate. Such beliefs are not confined to small business finance; they apply in housing and consumer finance as well. The beliefs typically reflect a combination of popular misperceptions about lending and anti-interest attitudes. These conditions encourage political response and influence the design of government assistance measures. The perceptions about lending are simple in nature and the evidence about antiinterest attitudes is impressionistic. Nevertheless a little elaboration is in order because of the economic costs involved.

Misperceptions About Lenders' Charges

Perceptions about lending can be viewed in relation to lenders' charges. These can be divided into interest and mark-up, with the latter covering transaction and other administrative costs, loan losses, and profits. There is some tendency to underestimate costs, and to overestimate profits. Lenders' interest costs may be ignored to some extent, as in expressions about "all that money that banks have" should enable them to make at least some loans at low rates. Being able to "create money by a stroke of the pen" implies that it is cheap. For banks and near banks, non-interest bearing chequing accounts may be thought of as a free source of funds. Chequing costs are either ignored or it is assumed that chequing charges cover them. Many borrowers may see appraisal costs as unnecessary in their case - their C's of credit are clearly positive and obvious. The C's may well prove to be positive but proof must be sought especially for small businesses which, as a class, are generally more risky than medium and large ones. There is undoubtedly underappreciation of the extent to which losses on one bad loan eliminate profits from many good ones. The obverse of a tendency to underestimate costs is a tendency to overestimate profits. In any case, financial institutions operate at high levels of leverage, so that a given percentage reduction in profits produced by reducing yields on loans and investments translates into a small decrease. Two recent studies, completed before the new Bank Act was passed, argued that banks make excess profits.(Economic Council of Canada, 1976; Lermer) If accepted, given their levels of leverage, removal of excess profits by lowering interest rates on loans and investments would have a small impact on the level of rates.

Altogether, the popular perceptions about lending do not point to much of a real economic gap. Nevertheless, so long as they are believed they enhance attitudes that interest rates should be lower and availability of funds greater.

Anti-Interest Attitudes as a Basis for Beliefs

Interest rates do not enjoy the same respectability as other market prices. Historically, penalties for non-payment of debts were harsh, including imprisonment. The practice of protecting borrowers against free market pricing has a very long tradition, dating from ancient times. For example (Boreham, p. 16-17):

- the ancient Hammurabi code included an interest rate ceiling of 33 1/3%.
- in the early Roman Empire, interest was limited to 8 1/3%.
- interest was deemed to be sinful by the canonists of the early Christian church.
- the Koran forbade interest charges.
- "John Calvin rejected the scriptural basis for interest prohibition...but still advocated some control on interest charges."
- Henry VIII imposed a ceiling rate of 10%.
- in the 18th century "most nations maintained legal maximum interest rates at 'reasonable levels'."
- from 1867 to 1944, the loan charge ceiling for Canadian chartered banks was 7%; from 1944 to 1967 it was 6%.
- before 1980, loans under $1500 by trust companies, credit unions and caisses populaires were limited to 12%.

Or as another writer has expressed it (Rolphe, p. 51):

> There exists, and always has existed, a bias against debt itself. It is found in the ancient Judaic law, which forbade lending; in the Catholic-medieval concepts of usury; in the Elizabethan drama as a pound of flesh; in the windy strictures of Polonius, who argues neither a borrower nor a lender be; and indeed in virtually every pre-industrial society known.

Current attitudes undoubtedly reflect this history. But more basically, it may be asked: Why is there this continuing social antipathy to interest?

Three reasons can be advanced. First, interest is a service and there may well be a popular view that goods are inherently more valuable than services. As one writer put it:

> The belief is widely held that real goods and their production have a value independent of their market value. There is a general tendency to overvalue real goods and undervalue equally essential services, equally essential in the sense that if the factors were diverted from their production, economic welfare would decrease.(MacDowell)

Among services, interest arises from a process which involves little tangible input in the form of labour and physical capital. Utility created by exchanging future and present consumption involves a subtler concept of production than utility created, say, by manufacturing or construction. Financing creates utility indirectly rather than directly. A subtle indirect process, of course, does not have less inherent value simply because the value is less readily perceived.

The second reason could be described as misplaced egalitarianism. Borrowers are popularly perceived as "poor" because they borrow, while lenders are popularly perceived as "rich" because they lend. (This view is held despite the fact that banks are our largest private debtors). Interest is thus a transfer payment from "poor" to "rich", from "have-nots to haves," and following from our first reason, from the "productive to the "nonproductive." This may well be an exaggerated view at least for the bottom third of the income scale, including its many retired persons. The low income groups are relatively unimportant as borrowers, but many hold claims of one kind or another against financial intermediaries. An interesting empirical question is whether a rise in interest rates produces a sizeable net interest transfer either to or from low income groups. Or alternatively: How do the incomes of small business owners compare with the average incomes of the labour force?

Perhaps the most important reason is the simple fact that there are times when the lender must say "no." In markets for goods and services other than capital the price of the product is more readily perceived and if the customer is willing to pay it, the transaction takes place. In debt markets lenders must not only refuse to sell to some applicants, but their refusal reflects upon the would-be buyer. Three C's of credit are character, capacity and capital. Also, insufficient collateral (the fourth C) may be seen as criticism by some rejected applicants. For the lender to try being tactful by attributing all rejections to business conditions (the fifth C) would be dishonest and transparent when other applicants are successful or when conditions are blatantly favourable.

Three Hypothetical Illustrations

Figure 2-3 illustrates three situations of market gaps attributable to beliefs that the supply curve should be lower. Illustration (a) is for medium to large sized low-risk loan borrowers. $S_aS'_a$ is the actual supply curve. It is highly elastic, reflecting the alternative that many of the borrowers have of reverting to the debt securities markets. S_sS_s is the supply curve that "should" exist. It is a little below $S_aS'_a$ on the presumption that there are few misperceptions about lending, little antipathy to interest and because the rates paid are at or near the bottom end of the rate structure.

Illustration (b) is more representative of small business financing. $S_aS'_a$ is at a higher level and less elastic. Risk and transactions costs are greater and borrowers lack the alternative of the securities market. $S_aS'_a$ is not for the highest risk class served by the lenders; there is no self-imposed ceiling. The interest rate gap is presumed to be greater because of misperceptions about lending, greater anti-interest attitudes because rates are higher, some feelings of being disadvantaged relative to large business and because some borrowers feel they belong in a lower risk class.

Illustration (c) is for a non-market. The interest rates which small businesses are prepared to pay (DD') for projects in the given risk class are less than the rates which lenders would have to charge for the risk involved. Thus, no debt transactions occur. (If DD' is high enough there may be a case for equity financing for some projects). As before S_sS_s is the supply curve that small business persons feel should exist. It intersects DD' so that the quantity gap is Q_s. Because there is no actual interest rate, the interest rate gap (?-i_s) is indeterminate.

Figure 2-3
FINANCING GAPS FOR RELOCATION OF SUPPLY SCHEDULE
THREE HYPOTHETICAL CASES

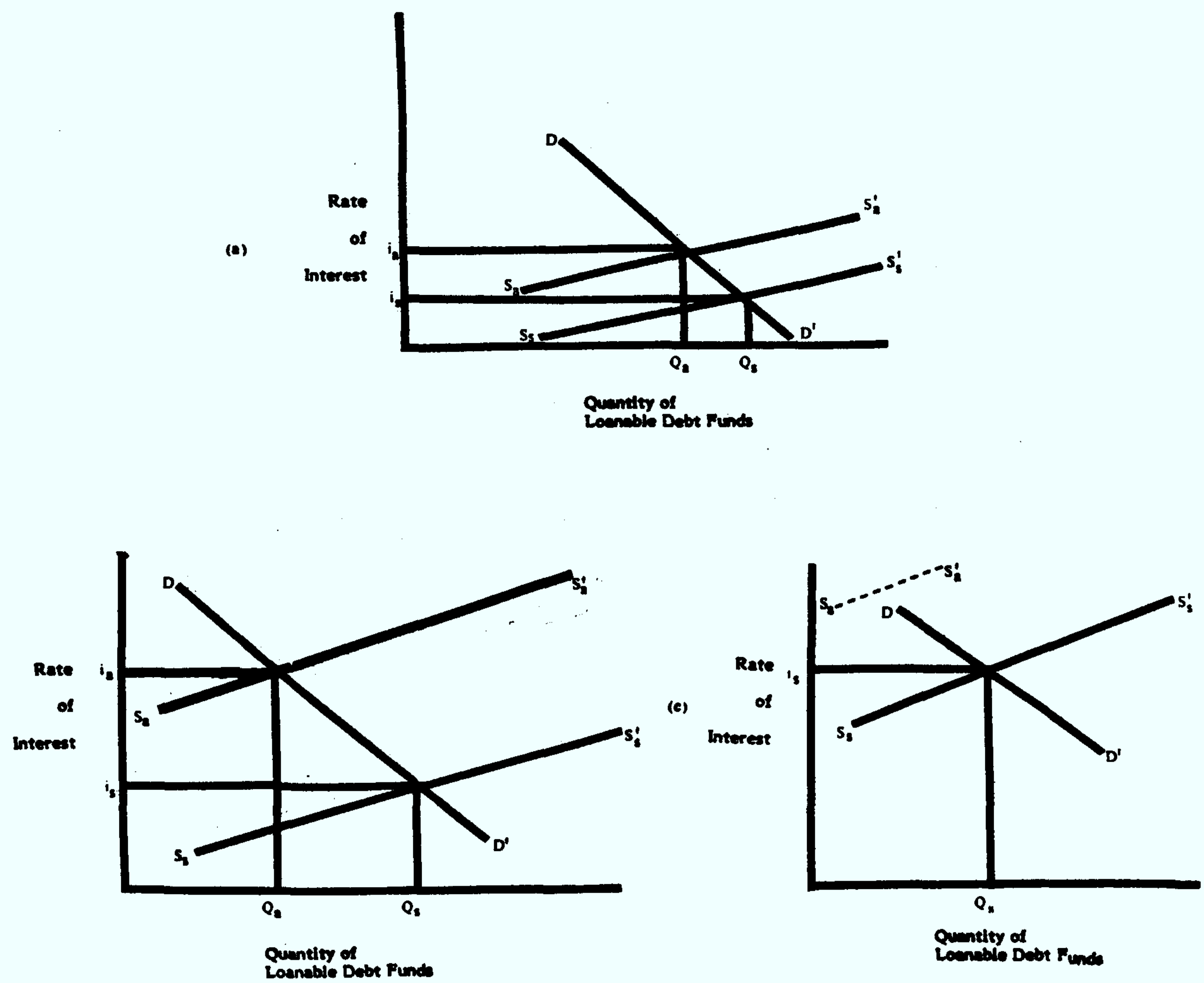


Illustration (c) is intended to underscore a basic point. As for other types of products, there are finite limits to the range of products in debt markets. There is a degree of standardization in lending processes to make them more efficient. Would-be products which do not fit standard processes may well cost more to produce than the market is prepared to pay for them. Where this happens with other types of would-be products, it is not common practice to argue that a gap exists and to call for government action to assist in filling it.

Small Business Roles

Externalities

Small business serves several roles in the economic system. Some of these produce benefits which do not accrue to the businesses themselves. These "externalities" provide a case for assisting small business in one way or another, on some selective basis. Subsidized financing is often used. It may or may not be the appropriate method, but that is a another subject. Arguments for subsidies can be viewed as another basis for believing that the supply curve for small business financing should be below its free market location.

Large numbers of small businesses produce routine products for small local markets. There are no obvious externalities associated with their activities. Some small businesses provide atypical products for which the market is small. In some cases, the products might have some strategic value from a national economy standpoint and thus provide an external benefit.

Small business is an outlet for independent spirits. Some persons simply wish to avoid working for others. In some cases, the wish may be sufficiently strong that an externality is involved. Those they leave behind can work better in their absence.

On the positive and more important side small businesses can provide opportunities for self-development. The resulting externalties are analogous to those produced by education. Also the small business sector includes some of the economy's most dynamic and innovative firms, which produce social benefits such as net growth in employment.

Both new, innovative and dynamic firms and established stable firms, may enhance competition in some markets. In some product markets, small firms are not so disadvantaged that they cannot affect the terms on which the large producers trade. Large firms are not necessarily large in all the product markets they serve.(Mitchell, p. 55)

In some instances where small firms cannot compete with large ones in a direct sense they may nevertheless improve the allocation of resources by complementing and supplementing the activities of large firms. As subcontractors for large firms, they may increase and quicken the adaptation of production to changing demand, to the benefit of the economy as well as themselves. (Mitchell, p. 55)

These roles of small business may argue for subsidizing it. Even if they do, it does not automatically follow that the subsidy should apply to the terms of supply of financing. Even if the capital market is used as a medium for assistance, the supply side of the market is not the only possible medium. The demand side should be considered.

Subsidies, of course, must be paid for. The high failure rate characteristic of small business means that subsidies can be wasteful and painful for those who fail. If a subsidy increases the failure rate, there is less to be said for it.

Demand Gaps

Public policymakers have usually turned their attention to the supply side of the capital market when explicitly addressing the subject of "financing gaps." For this reason, it may be asked: Is there an analogous concept that is applicable to the demand side of the market? If there is, would a balanced approach to improving the market in small business financing be more fruitful? Or, given the long-standing preoccupation with shortcomings of the supply side, might not efforts to improve the demand side have a higher marginal social payoff?

As we have defined it, a supply gap means an opportunity to improve the economy through improving the conditions of supply of financing. Analogously, a demand gap can be viewed as an opportunity to improve the economy through improving the conditions of demand for financing.

Two possibilities can be cited. The first is for borrowers to increase the quality or quantity of the financial skills in their firms. This may be a matter of the principals increasing their own financial skills if they manage the firm's finances themselves. Alternatively, it may be only a matter of increasing their ability to use effectively the financial skills of others. In some cases, skills may be sufficient but more time should be devoted to financial management. Where this would mean sacrificing management time devoted to more important activities the appropriate action would be to acquire more financial management services from others. There are several payoffs from improving financial management in a firm. Two are lower financing costs and easier access to funds, i.e. a reduction in demand gaps.

As firms grow, the requirements of management change. Management methods must be altered accordingly. What was appropriate or adequate at one size may be inadequate and risky at another. If management is unwilling to change its methods, it constitutes a barrier to growth. Where this type of barrier exists, the firm is unlikely to try to exploit all the profit making opportunities open to it. It may neglect expansion investments, but undertake replacement investments, even if the latter offer lower prospective returns, because replacements require little or no change in management methods. If this occurs, not only do profits suffer, but employment opportunities may be foregone as well. Reducing management's reluctance to change is a challenge for management education, on the job or otherwise. This is the second possibility for reducing demand gaps.

There is another payoff from improving management's skills in general. The quality of management is treated by some important lenders as the most important characteristic to evaluate in deciding about a loan. This indicates that one of the many payoffs from improving management skills may be the reclassification of the firm to a lower risk class.

It is noteworthy that, in recent years, both private and public lending institutions have increased their efforts to reduce demand side gaps.

Conclusions

1. The existence of significant supply gaps is not readily demonstrable on a prior grounds, except for some gaps caused by government regulation.

2. That diverse borrowers obtain financing on widely different terms and conditions does not prove that supply gaps exist.

3. Sometimes what are thought to be supply gaps are merely demands for financing that lenders cannot meet given the current state of their art.

4. There is a centuries old popular social belief that the terms of borrowing should be more favourable than those private lenders freely offer.

5. Public policy directed to improving the demand side of the market in small business financing could well be more productive than corresponding efforts on the supply side, especially in view of the traditional preoccupation with the latter.

Chapter 3

SIZE DISTRIBUTIONS OF FIRMS

by
James V. Poapst, George H. Haines, Jr. and Michael K. Berkowitz

It is easily appreciated that the division between small and large firms depends upon the analytical purpose for which the distinction is made. Also, it is common knowledge that the division between small and large firms varies by industry. Nevertheless studies of small business tend to rely on universal and somewhat arbitrary definitions of small business. This chapter presents a size distribution of firms in Canada and indicates its variation among major industries. Also included is an indication of how the size of small firms would vary when "small" is determined on a specific, analytically relevant basis. The illustration is drawn from a technical project conducted for this study (see Volume II Appendix A).

Size Distribution by Sales

Firms have many characteristics and as a result size can be measured in many ways. For studies of financing, sales and total assets are obvious choices. If a single-variable measure is to be used, sales have the advantage of being less subject to variation from accounting procedures than total assets. The latter are based on historical costs. Also, in the year for which data were available for independent Canadian firms, 1977, leased "assets" were not capitalized on the books of the lessee. While both sales and assets could be used jointly, it was felt desirable to avoid the statistical "noise" that would accompany the use of assets. Also, it was felt that if sales alone were used, it would throw light on the universal definition of small which was used in our interview surveys of lenders.

A size distribution of sales in dollars of firms in all industries is presented in Table 3-1. For unincorporated firms the distribution is for 1977, and for corporations it is for 1978. Totals are thus for 1977/8.

In 1977/8 there were some 529,000 firms of which about three-fifths were unincorporated. Unincorporated firms accounted for less than one-tenth of total sales.

The vast majority of firms are in the lowest sales ranges. Three-fifths of unincorporated firms had sales below $50,000 in 1977, and three-fifths of all firms had sales below $100,000. The unincorporated forms with sales below $50,000 accounted for nearly one-fifth of total sales by unincorporate firms. All firms with sales below $100,000 accounted for only 4% of sales.

Table 3-1

NUMBER OF FIRMS AND AMOUNT OF ANNUAL SALES, BY SALES CLASS UNINCORPORATED FIRMS, 1977, AND INCORPORATED FIRMS, 1978 (Percent)

Sales Under	Firms			Sales(est.)		
$000	Unincorporated	Incorporated	Total	Unincorporated	Incorporated	Total
50	59.0	22	43	18	0.3	2
100	80.0	35	61	38	1	4
200	93.0	52	75	60	3	7
500	98.0	74	88	84	7	13
1,000	99.5	85	94	92	13	18
2,000	99.7	92	98	96	20	25
5,000	99.8	97	98	97	30	35
Total	**100.0**	**100**	**100**	**100**	**100**	**100**
No.(000) or $B	307.0	221	529	25	326	351

Source: SBFR project. (For description see: D'Cruz).

By contrast only 0.2% of unincorporated firms, and 2% of all firms had sales of $5,000,000 or more. These unincorporated firms had 3% of total sales by unincorporated firms. The 2% of all firms with sales of $5,000,000 or more had 65% of total sales. Thus for all industries taken together a very large number of small firms has a very small market share while a very small number of large firms has a very large market share. The size distribution of firms is highly skewed.

Indications of variations by industry in what is small and what is very large are provided in Table 3-2. The seven industries shown individually account for proportions of total sales for all industries ranging from 12% to 4%, and aggregating to 53%. Firms with sales below $100,000 ranged from 41% to 68% of the total number of firms in their respective industries. The proportion for all industries was 61%. The shares of industry sales of these firms ranged from 0.1% to 10%, compared to the all industry average of 4%. Relative variation in proportion of sales was thus much larger than the relative variation in proportion of firms. Share of industry sales of the largest one percent of firms in the industry ranged from 41% to 82% compared to 59% for all industries.

Table 3-2

PERCENT OF FIRMS AND INDUSTRY SALES OF SMALLEST AND LARGEST FIRMS, UNINCORPORATED AND INCORPORATED, SEVEN LARGEST INDUSTRIES, 1977/8

	Sales in All Industries	Sales Below $100,000		Largest 1% Industry Sales
		Firms in the Industry	Industry Sales	
1. Retailers of General Merchandise	12	49	4	42
2. Wholesalers of Industrial Products	12	50	2	41
3. Construction Industry	8	68	10	37
4. Food, Beverage, Tobacco Products	6	38	.5	55
5. Transportation Equipment	6	41	.1	82
6. Mining and Petroleum	5	46	.4	74
7. Retailers of Food & Tobacco Products	4	42	3	61
All Industries	100 [a]	61	4	59

[a] Share of total for the seven industries was 53%.

Source: SBFR project.(For description see: D'Cruz.)

The data in Table 3-2 apply to firms which are clearly large and seemingly clearly small. To draw a more precise and more meaningful distinction between large and small more complex methods are necessary. As is shown below, use of these methods produces estimates of demarcation levels of sales which for some 3-digit SIC code industries are below $100,000 for 1977/8.

An Approach to Delineating Small Firms

Contrary to the requirements of equilibrium in neo-classical economic theory, empirical estimates of long-run cost functions rarely exhibit the familiar U-shape (Walter). They usually show decreasing costs per unit over lower levels of output, followed by relatively constant costs per unit. Firms operating under conditions of decreasing long-run average cost are at a competitive disadvantage compared to larger firms in the same industry which have reached the lower and horizontal component of their cost curve. Conceptually, one approach to distinguishing between small and large firms in an industry is to treat those operating at sales levels in which they are subject to decreasing unit costs as small, and those operating at higher sales levels as large.

To illustrate this approach Volume II Appendix A of this report was prepared. It should be noted that nothing in the approach requires the firms in the industry to have the same cost curves. If firms at one size use a process which differs from firms at another size, the estimates are not invalidated. Also, the method has the advantage that it simultaneously provides estimates of the impact of new firms in the large firm sector of the industry on increasing the industry's output. Since firms are typically born small, the impact of new firms in the large sector may serve as an indicator of the extent to which small firms can become large.

The basic data files used were developed by SBFR staff, based on 1977 data for unincorporated firms and 1978 data for corporations (see D'Cruz, et al.). The single year nature of the data prevents any analysis of change in sales limits of small firms over time. As data for additional years become available, further analysis could be made to test the method and the quality of results it produces. The subject of small firms growing into the large firm sector of an industry can be studied at the same time.

With only one year's data to work on, it would be premature to draw precise conclusions from the empirical findings to date. For this reason the findings are included in an appendix, with the exception of Table 3-3 below. Our main purposes here are to draw attention to the method and to encourage further research work on estimation procedures and alternative criteria to define small. It seems surprising that despite some 35 years of FBDB lending to "small" businesses little work appears to have been done to delineate such firms.

Estimated Sales Limits of Small Firms

A set of estimates of upper limits of sales for 198 SBFR Industry Code Categories is summarized in Table 3-3. To allow for so-called micro-firms, which employ only the owners and their families, one set of the estimates in Appendix A was prepared for firms with sales below $100,000 omitted. This omission does not preclude estimates of upper sales limits below $100,000 because of the nature of the estimating procedure. Fifteen percent of the upper limits were under $100,000 annual sales, and 71% were under $200,000. Only 2% of the maxima were over $1,000,000. The data and the estimating procedure used both tend to lead to a conservative estimate of the size in sales which distinguishes a large firm from a small firm. Thus it is possible the actual limits were higher than shown in Table 3-3. However, even if the limits were 100% higher they would be less than $1,000,000 for 97% of the SBFR Code Categories. Undoubtedly, the maxima increased with the expansion of dollar sales volumes since 1977/8. Even if the maxima in all categories doubled in size in the intervening years, however, they would be less than $2,000,000 for 97% of the SBFR Code Categories, other conditions remaining unchanged. Small business is very small indeed.

Table 3-3

DISTRIBUTION OF SBFR INDUSTRY CODE CATEGORIES, BY UPPER LIMIT OF SALES FOR SMALL FIRMS, 1977/8

Upper limit of sales	SBFR Code Categories	
$	#	%
under 50,000	0	0
50,000 to 99,999	29	15
100,000 to 199,999	111	56
200,000 to 499,999	51	26
500,000 to 999,999	2	1
1,000,000 and over	5	2
Total	**198**	**100**

Source: Volume II, Appendix A, Table A-2.

Taking the figures as they are, the maxima within the $50,000 to $499,999 sales groups range from $70,000 for other construction to $498,000 for veneer and plywood mills (See Table A-2). The ratio of high to low is 7.1 within the categories which include 97% of the maxima. The highest maximum was $8,073,000 for uranium mines followed by $1,701,000 for asbestos mines. There is thus sizeable absolute and relative variation in maxima, according to these estimates. They are probably most usefully thought of as giving information in an ordinal or ranking sense.

Conclusions

1. What is small, as determined by the methods reported in this chapter, is not only industry variable. It excludes in most industries size classes which major lenders would include in their view of small.

2. There is a need for more research in criteria and estimation procedures for delineating small business.

3. There is a need for further work using the method described in Volume II, Appendix A, which also deals with small firms growing into the large firm sector of industry. Estimates in Appendix A suggest that new large firms which contributed significantly to growth of sales in the industry occurred in only a minority of Canadian industries.

Chapter 4

SMALL BUSINESS FINANCING POLICIES AND PRACTICES: AN INTERVIEW SURVEY OF MANAGERS

by
Daniel B. Thornton

I. INTRODUCTION

Much of the research to date concerning the market for small business financing has been directed at identifying imperfections from the supply side. Data collected largely from the records of financial institutions has generally been taken to imply that small businesses were having difficulty obtaining various forms of financing that they needed. For example, the Report of the MacMillan Committee on Finance and Industry (1931) concluded that there was a shortage of long term capital available to small and medium sized firms in the U.K. owing to the lack of liquidity on the part of lenders and the high transaction costs per dollar loaned in that market. The report recommended that a new financial intermediary be established whose debentures, preferred shares, and common shares would trade publicly, establishing liquidity for investors, and whose mandate would be to make long term loans to and equity investments in small and medium sized businesses. This led to the establishment of the Industrial and Commercial Finance Corporation Limited in 1945, whose chief role was to close what is commonly referred to as "the MacMillan Gap" in the market for small business financing.

This public policy aproach seems to be a common one: create intermediaries to remedy perceived imperfections in the market for small business financing. Yet, forty years after the MacMillan recommendations and twenty-five years after the establishment of the new intermediary mentioned above, the Report of the Committee of Inquiry on Small Firms (1971) came to almost the same conclusions as the earlier report and made much the same recommendations. There was, in the opinion of its authors, inadequate equity financing available to small businesses. The inadequacy could be remedied only by the establishment of a new intermediary whose purpose would be to channel equity capital to the small business sector. Moreover, the report stated that even in 1971, more than nine out of ten British firms had never looked beyond their local banks for finance. Reliance of small firms on short term bank loans for long term capital left the small business sector in the U.K. highly vulnerable to rationing of capital by monetary authorities or to major swings in the market rate of interest, according to the report.

Why do these alleged small business financing problems appear to persist in study after study, year after year, decade after decade, despite the attempts by governments to remedy them? Our research was motivated largely by a suspicion - corroborated by our results - that there must be something about the demand side of the small business financing market that somehow makes it immune to supply-side attempts to improve it. Our primary research objective, therefore, is to provide what we view as a long-overdue study of the demand side of Canada's small business financing market.

Objectives of the Study

The overall objective of the demand side survey is to obtain information from a sample of small businesses concerning their financing with a view to identifying ways in which the government, NBFIs or other interested parties may be able to assist them in achieving their full potential. To set the stage for this endeavour, we have focused our analysis on three general objectives:

(i) to determine whether there is evidence to support the claim that "gaps" exist in the financing of small business which prevent this sector from maximizing its contribution to the Canadian economy.

(ii) To determine whether there is evidence of significant voluntary under-exploitation of current available profit making opportunities by small businesses. (Often referred to as "self imposed capital rationing".)

(iii) To identify opportunities to facilitate the flow of funds from savers to small businesses either within the present institutional structure or under new arrangements.

The essential question that needs to be addressed by government policy makers is whether specific public sector intervention in the small business financing market is necessary or desirable. As a point of departure, we offer a quotation from R.H. Coase's seminal article, The Problem of Social Cost. (Journal of Law and Economics, 1960) Coase argues that government intervention can be beneficial, but only if the cost of using (private) markets is higher than the cost of organizing similar transactions by some central planner.

> The government is, in a sense, a superfirm (but of a very special kind) since it is able to influence the use of factors of production by administrative decision...It is clear that the government has powers which might enable it to get some things done at a lower cost than could a private organization...From these considerations, it follows that direct governmental regulation will not necessarily give better results than leaving the problem to be solved by the market or the firm. But equally, there is no reason why, on occasion, such governmental administrative regulation should not lead to an

> improvement in economic efficiency. This would seem particularly likely when, as is normally the case with smoke nuisance, a large number of people are involved and in which therefore the costs of handling the problem through the market or the firm may be high. (pp. 17-18)

The point was made to us repeatedly at the inception of the study, particularly by managers of NBFIs, that the administrative costs of making loans to small businesses were very high. We were sensitive, too, to the possibility that search costs for finance by small business managers could be quite substantial. These would be largely opportunity costs, since search time would logically leave no one "minding the store." Consequently, it appeared to us that the costs of using financial markets **could** be considerable in the small business sector and that government intervention **might** have a role to play.

Nonetheless, we wish to emphasize most emphatically that we view the appropriateness of intervention by governments in this market as an empirical question. Our initial position in this study is simply that no intervention is desirable unless the evidence available indicates that it is warranted. Such evidence, if it existed, would show clearly that a significant number of soundly managed firms in this sector were being constrained only by lack of finance or by excessive cost of finance. By "cost", however, we do not mean interest cost. In our view, interest is merely one of many prices that serve to allocate scarce resources in our economy. Price subsidies in this market necessarily involve sacrifices in others, and we have no way of knowing whether such redistributions are desirable. Rather, by "cost" we mean search and administrative costs that could be potentially reduced by government involvement or by innovation by NBFIs on the supply side.

Of course, these costs or gaps in the market cannot be identified directly. We have tried to derive proxies for them by administering a carefully constructed questionnaire to a sample of approximately 300 small businesses in ten centres across Canada. To derive the proxy measures, we identified the following key areas of enquiry:

(i) The resources for financial decision making, financing policy, financial planning practices and management of financial risk in small businesses.

(ii) Capital market search procedures, recent experience regarding all types of financing sought, the perceptions of small business financial decision makers about amounts of funds available relative to amounts sought, about how well their capital suppliers have served them, and the consequences of not being able to finance their needs.

(iii) The objectives of the business and the importance of financing relative to other common types of problems that may inhibit small businesses in pursuing their objectives.

(iv) The awareness of federal government assistance programs and suggestions for improving the market for small business financing, including government policy.

As an example of a proxy measure, suppose that we found that there was extensive shopping for funds by a segment of the small business population. Then it would be difficult indeed to argue that the segment faced exorbitant search costs for capital. On the other hand, restrictive search procedures and dissatisfaction with sources of supply would indicate that the segment **might** be incurring excessive costs in using the price system of allocating capital.

A copy of the questionnaire is included as Appendix B-1. We suggest that the reader examine the questions posed at this time, keeping in mind the four general lines of enquiry listed previously.

Analysis

We see essentially six independent variables that may explain certain aspects of problems that may face small businesses in need of financing in Canada:

- size, age and scope of business
- financial position and earnings record
- industry
- depth of financial management
- stated objectives of the business and stage in life cycle
- location

In this report, we use these independent variables to explain variations in the following dependent variables:

- relative importance of financing problems among other problems facing small business.
- types of financing obtained in the past and planned in the future
- mismatching maturities (short term for long term purposes)
- degree of satisfaction from various lending institutions and other sources of capital.
- search procedures for financing
- problems induced by actual and contingent lack of financing
- awareness of government assistance policies
- demand for related financial services
- **impressionistic ideas** - how government could help more; how well satisfied they have been with financial services from various sorts of intermediaries (and particularly chartered banks)

As was mentioned in the introduction, an important aspect of the study will be to link findings from the demand side study with the supply side findings. A major concern will be to identify new opportunities for suppliers to meet the demand identified and to recommend policies whereby information can be disseminated to lenders and borrowers in the private sector to facilitate market clearing with minimal search costs.

Organization of the Chapter

The remainder of the chapter is divided into five sections. The second section describes the research design employed in the study. The third is a profile of how the respondents answered the questions: emphasis is put on the parts of the profile that are most important for public policy makers and non-bank financial institutions. The fourth section is an analysis of some key public policy questions using cross tabulation, breakdown and multivariate discriminant analysis. The fifth section summarizes the implications of our work for public policy makers and for NBFIs. Section VI is an addendum describing how the respondents answered open-ended questions and how such answers were postcoded for computer analysis.

II. RESEARCH DESIGN AND PROCEDURES

For the purpose of this study ten metropolitan areas were selected. These included the three largest--Toronto, Montreal and Vancouver--along with Calgary, Saskatoon, Winnipeg, Kitchener, Quebec, Halifax and St. John, chosen to provide coverage of medium sized centres and more provinces. Altogether metropolitan areas from eight provinces were selected.

This selection allowed us to allocate our limited resources to geographic areas where a large proportion of the small business population is located, while recognizing possibilities for variations between regions and between large and small metropolitan areas. (The supply side portion of the study suggests that in the metropolitan areas some private lenders such as trust companies and financial companies are more active.)

After due consideration, it became apparent that the only reasonable source of names of businesses in which we were interested was Dun & Bradstreet. Accordingly, the following sample selection procedures were devised and implemented.

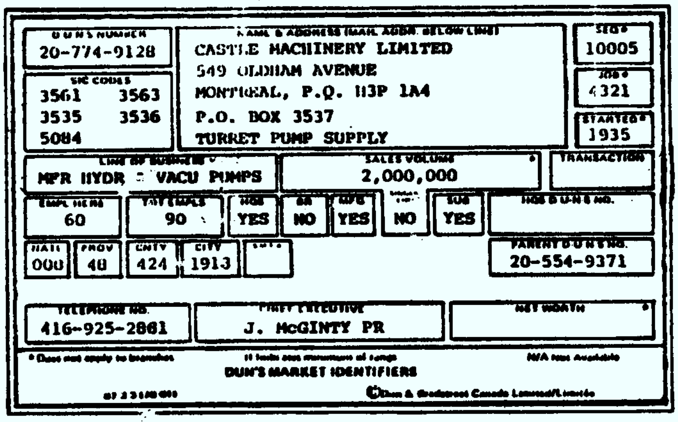
Sample Selection

Appendix B-2 outlines the sample selection procedure. First, a master tape was prepared of the firms of concern to the study:

Criterion #1: Not large or self-employment firms. This criterion provides different sales ranges for each industry as is evident in Appendix B-2. Initially, the sales ranges were obtained by visual inspection of data on

Exhibit 1

DUNS MARKET IDENTIFIERS (DMI)



DUNS NUMBER 20-774-9128

NAME & ADDRESS (MAIL ADDR. BELOW LINE)
CASTLE MACHINERY LIMITED
549 OLDHAM AVENUE
MONTREAL, P.Q. H3P 1A4
P.O. BOX 3537
TURRET PUMP SUPPLY

SEQ 10005 | JOB 4321 | STARTED 1935

SIC CODES 3561 3563 3535 3536 5084

LINE OF BUSINESS MFR HYDR & VACU PUMPS | SALES VOLUME 2,000,000 | TRANSACTION

EMPL HERE 60 | TOT EMPLS 90 | YES | NO | YES | NO | YES

NATL 000 | PROV 48 | CNTY 424 | CITY 1913

PARENT D-U-N-S NO. 20-554-9371

TELEPHONE NO. 416-925-2881 | CHIEF EXECUTIVE J. McGINTY PR | NET WORTH

DUN'S MARKET IDENTIFIERS

©Dun & Bradstreet Canada Limited/Limitée

A D-U-N-S number to identify the account on computer.

B Standard Industrial Classification code (SIC) to identify companies who buy your product.

C Description of business. How does your product fit in?

D Employee size indicates how much of your product is needed.

E Geographical codes can be used to sort prospects into territories.

F Telephone number gives you immediate contact.

G Legal Company name properly identifies your prospect.

H Postal code can be used to set up call routes.

I Tradestyle gives name Company is usually known by.

J Sales volume indicates the size of business and how much supply it needs.

K Headquarters, single location or part of a branch network. This indicates size of purchase.

L Does manufacturing take place on the premises?

M Parent or headquarters D-U-N-S numbers represent other members of the corporate family.

N Starting date may identify a new company looking for supplies or a firm so established its suppliers take it for granted.

O Chief Executive's Name and Title — your top decision maker.

P Financial worth information is available to Dun and Bradstreet credit service subscribers. Use this to measure a prospect's strength.

Applications	Benefits
1 Computer-select your specifications	discover new markets
2 Measure sales potential	set sales quotas
3 Pre-qualify your prospects	increase sales efficiency
4 Pre-plan sales calls	increase your sales growth
5 Compare with your present markets	pinpoint rapid growth areas
6 Direct mail follow-up	maintain a comprehensive sales effort

frequency distributions of firms by sales volume supplied by the federal government. The minimum sales cut-off was $100,000 per annum uniformly, for all industries, but upper cut-off points were different for each industry reflecting our view that the term "small" means different things in different industries. (See chapter 3 for discussion of this point).

Previous work in the area has defined size in terms of the perceptions of the suppliers of capital: what constitutes a big loan or a small loan as far as the **lender** is concerned. Our view is that this may miss the point as far as public policy is concerned. The chief concern of public policy for financing is most logically directed not at **financing** amounts below a certain size, but at firms of **any size** that are at the point where, with financing assistance (or other appropriate assistance), they may break out of the potentially cost-inefficient scale at which they are operating and assume a more dominant role in Canadian business: a small oil refiner may have larger dollar sales volume than a very large restaurant, and government policy makers may wish to adopt new perspectives in their consideration of which small business should be eligible for subsidies.

It should be noted here that once the field work commenced, the interviewers found that in the Quebec City area, the $100,000 floor was too low for retail grocery stores, service stations, restaurants and independent labourers working largely through sub-contracts. It introduced too many family-type sole proprietorships who had no need for external financing and whom the purpose of the floor was to excise from the sample. Accordingly, approval was given to the interviewers to raise the floor criterion to $200,000 in these industries in Quebec City and Montreal.

Criterion #2: Independent: no branches or subsidiaries were allowed. Dun and Bradstreet was able to eliminate these from the sample.

Criterion #3: Location: in one of the 10 metropolitan centres or its hinterland.

From these criteria, D&B constructed an universe of 195,384 firms eligible to be interviewed. From this universe, 3,159 names (referred to as the "gross sample") were generated to provide a random sample of the universe stratified by location. Dun's Market Identifier information for each of the firms in the gross sample (Exhibit 1) was sent to the interviewing firm, Woods Gordon, directly in order to preserve the confidentiality of the interview process. The instructions were to endeavour to set up interviews with 300 of these 3,159 firms by contacting them in the random order in which they appeared on the D&B listings for the respective locations until the following numbers were filled:

Location	No. of Interviews
Halifax, N.S.	20
St. John, N.B.	20
Quebec City, P.Q.	20
Kitchener, Ont.	20
Winnipeg, Man.	30
Saskatoon, Sask.	20
Calgary, Alta.	30
Vancouver, B.C.	35
Montreal, P.Q.	50
Toronto, Ont.	55
Total	**300**

Enough of Dun's Identifiers were supplied to Woods Gordon to allow for a very low response rate of 10% in each location. As reported later, the response rate was 22% and 292 questionnaires were successfully administered (see Exhibit 2).

Exhibit 2

NUMBERS OF COMPLETED QUESTIONNAIRES BY CITY

Halifax	20
St. John	20
Quebec City	19
Montreal	47
Toronto	55
Kitchener	20
Winnipeg	30
Saskatoon	20
Calgary	26
Vancouver	35
	292
Spoiled	8
Total	**300**

Exhibit 3 profiles the Universe, Gross Sample and 292 Interview firms by sales range. Exhibit 4 shows the distribution by sales range of firms in the gross sample in the ten centres. Exhibit 5 compares the interview firms with those in the universe by primary industry, and Exhibit 6 gives a crosstabulation of firms interviewed by sales and city. Some of the discrepancy between the distribution of interviewed firms and the distribution of the D & B universe was occasioned by the decision to increase the floor sales cut-off to $200,000 in Quebec City and Montreal. The rest must be attributed to non-response bias. Of course, it is debatable how close the D&B universe approximates the true universe of small independent businesses in Canada, as we have defined them. For instance, if a large class of small businesses chose not to be listed on the D&B file, the generality of our findings even for the 10 locations could be questioned. D&B officials assure us, however, that in the 10 centres virtually all small businesses that wish to operate on credit choose to register with the credit rating agency.

Exhibit 3

COMPARISON OF UNIVERSE, GROSS SAMPLE, AND INTERVIEW FIRMS BY SALES RANGE

Sales Range $	**Universe**	**Gross Sample**	**Interviews (292-July 1981)**
100,000 - 2 million*	90%	89%	79%*
2-3 million	4	4	6
3-5 million	3	4	7
5-15 million	3	3	9
15-25 million	0	0	0
25-40 million	0	0	0
40-75 million	0	0	0
	100%	**100%**	**100%**

INTERVIEWS - ANOTHER TABULATION

Sales Range $	**Per Respondent**	**Per D&B**
50,000-200,000	7%	12%
200,000-500,000	21	25
500,000-1,000,000	20	21
1-10 million	47	40
Over 10 million	5	2
	100%	**100%**

*Some of the difference in the distributions is explained by a decision made in the field to increase the floor sales level in the Quebec City and Montreal from $100,000 to $200,000 as explained in the text.

Exhibit 4

DUN & BRADSTREET GROSS SAMPLE
NUMBER OF FIRMS BY SALES RANGE IN THE 10 CENTRES

	$100,000 to 2 million	2-3 million	3-5 million	5-15 million	15-25 million	25-40 million	40-75 million	Total
Halifax	184	9	7	6	1			207
St. John	243	8	9	9	3	1		273
Quebec	194	5	9	9				217
Kitchener	182	6	9	9	2	1	1	210
Winnipeg	277	12	15	9	1			314
Saskatoon	204	8	7	3	3	1		226
Calgary	259	20	11	13	1			304
Vancouver	315	16	7	10	1			349
Montreal	448	13	18	19	1	1		500
Toronto	493	25	23	16	2			559
	2,799	122	115	103	15	4	1	3,159
%	89	4	4	3	0	0	0	100

Exhibit 5

PROFILE OF FIRMS BY PRIMARY INDUSTRY

	Interview (292 firms)	D&B Universe
Mining	1%	1%
Construction	15	16
Manufacturing	22	15
Transportation & Utilities	7	5
Wholesale	21	13
Retail	18	34
Services	16	16
	100%	**100%**

Note: Some of the differences are due to a decision to increase the minimum level of sales in the Quebec City and Montreal for retail food stores, service stations, and restaurants from $100,000 to $200,000.

A more detailed breakdown by industry of the D&B universe in the ten centres is given in Appendix B-3.

Exhibit 6

CROSS-TABULATION OF INTERVIEWED FIRMS BY INDUSTRY AND LOCATION*

		Halifax	St. John	Que. City	Montreal	Toronto	Kitchener	Winnipeg	Saskatoon	Calgary	Vancouver	Row Total
MANUFACTURING	count	2	2	2	12	21	5	4	3	4	8	64
	row %	3.1	3.1	3.1	18.8	32.8	7.8	6.3	4.7	7.8	12.5	
	col %	10.5	10.0	10.5	25.5	38.2	25.0	13.3	15.0	19.2	22.9	
	tot %	0.7	0.7	0.7	4.1	7.2	1.7	1.4	1.0	1.7	2.7	22.0
WHOLESALE	count	5	5	6	8	11	4	10	3	1	9	62
	row %	8.7	8.1	9.7	12.9	17.7	6.5	16.1	4.8	1.6	14.5	
	col %	26.3	25.0	31.6	17.0	20.0	20.0	33.3	15.0	3.8	25.7	
	tot %	1.7	1.7	2.1	2.7	3.8	1.4	3.4	1.0	0.3	3.1	21.3
RETAIL	count	6	6	5	13	3	4	6	4	1	3	51
	row %	11.8	11.8	9.8	25.5	5.9	7.8	11.8	7.8	2.0	5.9	
	col %	31.6	30.0	26.3	27.7	5.5	20.0	20.0	20.0	3.8	8.6	
	tot %	2.1	2.1	1.7	4.5	1.0	1.4	2.1	1.4	0.3	1.0	17.5
OTHER	count	6	7	6	14	20	7	10	10	19	15	114
	row %	5.3	6.1	5.3	12.3	17.5	6.1	8.8	8.8	16.7	13.2	
	col %	31.6	35.0	31.6	29.8	36.4	35.0	33.3	50.0	73.1	42.9	
	tot %	2.1	2.4	2.1	4.8	6.9	2.4	3.4	3.4	6.5	5.2	39.2
	COLUMN TOTAL	19	20	19	47	55	20	30	20	26	35	291
		6.5	6.9	6.5	16.2	18.9	6.9	10.3	6.9	8.9	12.0	100.0

Exhibit 6

*Note: In our cross-tabulations, "row %" or "row pct." refers to the percentage of observations in that row which were found to be in the related column. For example, in the upper left of the table above, 2 manufacturers were in Halifax, representing 0.7% of the whole sample, 3.1% of the 64 manufacturers, and 10.5% of all of the Halifax firms.

Development of Questionnaire and Pretest

A questionnaire for a structured direct interview by Woods Gordon personnel, with several open-ended (probing) questions, was developed. Following a literature review, culling personal and professional experience and, most important, six indepth interviews using a preliminary questionnaire as a guide, the questionnaire in appendix B-1 was developed.

The questionnaire was translated into French by the translation staff of Woods Gordon. As usual, for cross checking purposes more than one translator was used. It was decided to use senior personnel of Clarkson Gordon, Woods Gordon's accounting affiliate, to conduct the interviews. All interviewers were Chartered Accountants.

The six pre-survey depth interviews were not conducted with arm's length subjects. The formal pretest was a follows. A list of 60 small businesses in Toronto was obtained from a local service organization and sent to Woods Gordon (WG). The field procedures described below were followed, except that the list of potential contacts was not supplied by D&B. This measure was taken to expedite the study. Of the 16 firms actually contacted, 11 were interviewed by Woods Gordon.

The formal pretest resulted in two minor revisions of the pre-test questionnaire, in consultation with government sponsors. The response rate was over 70% and the field procedure appeared to be working well. Accordingly, the final interviews were begun as soon as WG received the D&B identifiers for the gross sample.

Field Procedures

Contact with potential interviewees was initiated by letter from the local managing partner of the Clarkson Gordon office with personal signature. This was followed up by telephone by each local office's Supervisor of Interviewers to determine whether the recipient would be interviewed and to arrange the time.

Experienced audit staff in the consultant's local office conducted the interviews under central direction. Interviewer kits containing a copy of Interviewer Guidelines (see Appendix B-4), the questionnaire, and the Department of Industry, Trade and Commerce's publication, **Incentives for Industry** were distributed to the interviewers in advance. Then half-day training sessions were held in each metropolitan centre by the consultant's Interview Director.

Interviewees were provided with folders designed for the survey, carrying the imprint of FACSYM with a card bearing the interviewee's name, position, and firm inserted in a pocket designed for the purpose. The folder included a copy of the questionnaire and a copy of a Woods Gordon publication, **Tomorrow's Customers.**

Quality Control and Follow Up

After the interviews were completed a telephone call was placed to every tenth potential small business respondent from the D&B list by a market research firm experienced in administering telephone interviews. A copy of the brief questionnaire is included in Appendix B-6. Statistics relating to the follow up survey are tabulated in this appendix, and compared with those in the main survey. The firms in the main survey were larger than those in the follow up, owing to the change in field procedures outlined in exhibit 2. Nonetheless, we can report with confidence that this disparity in size does not affect the conclusions or recommendations of the study. See Appendix B-6 for the detailed justification of this assertion.

Response Rate

Clarkson Gordon's response rate statistics are presented in Exhibit 7. The computation of non-response rates is to some extent a subjective process. The lower part of Exhibit 7 relates to cases that clearly cannot be counted as non-responders, because they were either ineligible to be interviewed or were not in existence in the form indicated by the Dun's Market Identifiers. Firms in the categories listed in the top portion of the Table were all eligible for interviews, but whether the failure of Woods Gordon to arrange an interview constitutes "non-response" is a matter of opinion for each category. As the figures in the exhibit show, a very conservative interpretation would imply a 22% response rate overall, ranging from 15% in Toronto to 47% in Halifax.

Exhibit 7

RESPONSE RATE BY LOCATION

	Total	Halifax	St. John	Que. City	Montreal	Toronto	Kitchener	Winnipeg	Saskatoon	Calgary	Vancouver
1 Interviewed	301	20	20	20	50	56	20	30	20	30	35
2 Interested, but could not meet before deadline	125		8	12	10	3	10	13	9	50	10
3 Unable to contact	417	8	22	3	85	168	1	9	2	48	71
4 Too busy to participate	171	4	5	5	40	64	12	5	8	12	16
5 Not interested	371	10	18	21	79	78	15	37	10	42	61
6 Refused - confidentiality	4	1	1				1			1	
	1389	43	74	61	264	369	59	94	49	183	193
RESPONSE RATE											
Counting 2 and 3 as non response	22%	47%	27%	33%	19%	15%	34%	32%	41%	16%	18%
not counting 3 as non response	31%	57%	38%	34%	28%	28%	34%	35%	43%	22%	28%
not counting 2 or 3	36%	57%	45%	43%	30%	28%	42%	42%	53%	35%	31%
GROSS SAMPLE FIRMS NOT CONTACTED											
1 Too small - Montreal & Que.	101			33	67						1
2 Not in existence	93	3	6	11	4	46		1	1	8	13
3 Changed or changing hands	14		2	6		1	1			4	
4 Ineligible to be interviewed	8					3			1	2	2
	216	3	8	50	71	50	1	1	2	14	16
TOTAL IDENTIFIED FIRMS	1605	46	82	111	335	419	60	95	51	197	209

III. A PROFILE OF ANSWERS TO THE QUESTIONNAIRE

Answers to the questions based on the 292 completed interviews are tabulated in Appendix B-5. In this section, we review and analyze the tabulation and to the extent that we can, make observations that are relevant to public policy. The discussion in this section relates only to tabulations of single variables or relationships between pairs of variables. Inferences drawn from this type of analysis can be misleading if there are several causal variables operating simultaneously. Multivariate analysis is performed in Section IV.

A. The Respondents

The median value for sales in the sample was approximately $890,000, according to both D&B and the respondents. D&B did not report net worth for most firms in the sample: only 47 were reported and of those, the median value was $375,000. The median number of employees was 12 according to D&B and 13 according to the respondents. There was no disagreement in the distributions of numbers of employees between the D&B file and the questionnaire results. There was some disagreement between D&B and the respondents as to the start up years of the businesses: on the average, the respondents reported that their firms had been in business longer than D&B had indicated. We believe that the answers of the respondents are more accurate than the information on the D&B market identifiers because D&B usually reports the date of listing with their firm as the start up year. Accordingly, we report that about half of the interviewed firms were started before 1963 and half after. One in four began operations after 1970. Therefore, though the sample reviewed here does satisfy the criterion of containing small independent businesses as we defined them, the sample certainly cannot be said to contain a preponderance of **new** businesses. Three quarters of the respondents have been in business for ten years or more.

Forty percent of the businesses in the sample distributed their product or service locally (in town). Provincial, multi-province and national firms made up the other 60% with national ones accounting for 20%. In addition, one in five of the respondents reported that they exported their goods or services to other countries. Total assets for the respondents had a median value in the range $200,000 to $500,000.

Three quarters of the firms in the sample reported growth in sales of 0-20% per year, with 12% reporting no growth at all or even shrinkage in annual sales volume. As for financial management, all firms in the survey responded to question 7 of the questionnaire: of these, one in four had a full time specialized financial manager. Regardless of whether the manager was full time or not, one in four of the repondents said that the person responsible for their firms' finances had a formal accounting or financial designation.

Exhibits 8 - 12 are profiles of the sample firms by location. Exhibit 8 shows that there are differences in size and age of the firms by location. Exhibit 9 demonstrates that there was a tendency for firms in the Atlantic provinces to distribute their products or services only locally, whereas Toronto and Montreal based firms were much more likely to engage in national distribution. In Exhibit 10, it is to be noted that the Toronto and Montreal firms also tended to export their products or services more frequently than others. Though Kitchener firms were also very significant exporters, this is probably a size effect rather than a pure location effect, since Exhibit 8 showed that the Kitchener firms interviewed tended to be quite large. This example points up the danger in drawing inferences from analyses such as cross-tabulations and the consequent need for the multivariate approach taken in section IV of the chapter: in multivariate analysis, size and location can be handled simultaneously, each being allowed to explain as much about the data as it can in tandem with other important variables. Calgary and Vancouver firms also tended to export more than some of the others.

Exhibit 8

PROFILE OF SELECTED DATA BY CITY

	Dun & Bradstreet Statistics						Per respondent	
	Sales ($\$ \times 10^{-6}$)		No. of Employees		Start-up Year		No. of Employees	
	Mean		Mean		Mean		Mean	
Halifax	1.56	2.66*	19.4	21.6	1959	13	17.7	21.6
St. John	1.21	1.51	15.4	15.9	1957	12	21.4	21.8
Quebec City	2.00	2.95	40.9	72.0	1961	11	38.6	70.6
Montreal	1.92	2.39	28.1	26.1	1964	12	25.6	23.3
Toronto	1.33	1.75	27.5	40.1	1965	10	27.9	36.0
Kitchener	2.29	2.48	57.4	64.9	1955	16	63.2	88.4
Winnipeg	2.12	2.74	25.2	36.3	1961	7	27.7	47.0
Saskatoon	2.36	2.53	27.5	22.0	1962	12	27.6	22.8
Calgary	1.85	2.22	20.1	24.1	1970	6	29.5	32.6
Vancouver	1.31	1.54	12.7	15.1	1968	9	15.7	24.2
ENTIRE POP.	1.74	2.25	26.5	37.8	1963	11	28.4	42.1
NO. OF OBSERV.		288		290	289			

*Standard deviation

Exhibit 9

WHICH OF THE FOLLOWING CATEGORIES BEST DESCRIBES WHERE YOU ACTIVELY DISTRIBUTE YOUR PRODUCTS OR SERVICES?

		Halifax	St. John	Que. City	Montreal	Toronto	Kitchener	Winnipeg	Saskatoon	Calgary	Vancouver	Row Total
LOCALLY	count	12	11	7	21	19	7	10	9	12	14	122
	row %	9.8	9.0	5.7	17.2	15.6	5.7	8.2	7.4	9.8	11.5	
	col %	63.2	55.0	36.8	44.7	34.5	35.0	33.3	45.0	46.2	40.0	
	tot %	4.1	3.8	2.4	7.2	6.5	2.4	3.4	3.1	4.1	4.8	41.9
PROVINCIALLY	count	3	5	9	8	8	8	3	6	5	5	60
	row %	5.0	8.3	15.0	13.3	13.3	13.3	5.0	10.0	8.3	8.3	
	col %	15.8	25.0	47.4	17.0	14.5	40.0	10.0	30.0	19.2	14.3	
	tot %	1.0	1.7	3.1	2.7	2.7	2.7	1.0	2.1	1.7	1.7	20.6
MULTI-PROVINCE	count	2	3	2	5	1	0	16	2	7	12	50
	row %	4.0	6.0	4.0	10.0	2.0	0.0	32.0	4.0	14.0	24.0	
	col %	10.5	15.0	10.5	10.6	1.8	0.0	53.3	10.0	26.9	34.3	
	tot %	0.7	1.0	0.7	1.7	0.3	0.0	5.5	0.7	2.4	4.1	17.2
NATIONALLY	count	2	1	1	13	27	5	1	3	2	4	59
	row %	3.4	1.7	1.7	22.0	45.8	8.5	1.7	5.1	3.4	6.8	
	col %	10.5	5.0	5.3	27.7	49.1	25.0	3.3	15.0	7.7	11.4	
	tot %	0.7	0.3	0.3	4.5	9.3	1.7	0.3	1.0	0.7	1.4	20.3
	COLUMN TOTAL	19	20	19	47	55	20	30	20	26	35	291
		6.5	6.9	6.5	16.2	18.9	6.9	10.3	6.9	8.9	12.0	100.0

Exhibit 10

DO YOU EXPORT PRODUCTS OR SERVICES TO OTHER COUNTRIES?

	Halifax	St. John	Que. City	Montreal	Toronto	Kitchener	Winnipeg	Saskatoon	Calgary	Vancouver	Row Total
count	2	1	1	11	17	8	4	2	5	6	57
row %	3.5	1.8	1.8	19.3	29.8	14.0	7.0	3.5	8.8	10.5	
col %	11.1	5.9	5.3	26.2	33.3	40.0	14.3	10.0	23.8	18.8	
tot %	0.7	0.4	0.4	4.1	6.3	3.0	1.5	0.7	1.9	2.2	21.3
count	16	16	18	31	34	12	24	18	16	26	211
row %	7.6	7.6	8.5	14.7	16.1	5.7	11.4	8.5	7.6	12.3	
col %	88.9	94.1	94.7	73.8	66.7	60.0	85.7	90.0	76.2	81.3	
tot %	6.0	6.0	6.7	11.6	12.7	4.5	9.0	6.7	6.0	9.7	78.7
COLUMN	18	17	19	42	51	20	28	20	21	32	268
TOTAL	6.7	6.3	7.1	15.7	19.0	7.5	10.4	7.5	7.8	11.9	100.0

No. of missing observations = 24

Exhibit 11

APPROXIMATELY HOW FAST (ON AVERAGE) HAVE YOUR ANNUAL SALES BEEN GROWING OVER THE PAST THREE YEARS? PLEASE CHECK CATEGORY.

		Halifax	St. John	Que. City	Montreal	Toronto	Kitchener	Winnipeg	Saskatoon	Calgary	Vancouver	Row Total
NO GROWTH, SHRINK	count	3	2	3	7	5	5	6	0	0	2	33
	row %	9.1	6.1	9.1	21.2	15.2	15.2	18.2	0.0	0.0	6.1	
	col %	15.8	10.0	15.8	15.6	9.6	25.0	20.0	0.0	0.0	5.7	
	tot %	1.1	0.7	1.1	2.5	1.8	1.8	2.1	0.0	0.0	0.7	11.6
0 - 10%	count	8	7	10	15	12	4	13	6	2	6	83
	row %	9.6	8.4	12.0	18.1	14.5	4.8	15.7	7.2	2.4	7.2	
	col %	42.1	35.0	52.6	33.3	23.1	20.0	43.3	30.0	8.0	17.1	
	tot %	2.8	2.5	3.5	5.3	4.2	1.4	4.6	2.1	0.7	2.1	29.1
10 - 20%	count	8	7	4	17	20	9	9	9	9	13	105
	row %	7.6	6.7	3.8	16.2	19.0	8.6	8.6	8.6	8.6	12.4	
	col %	42.1	35.0	21.1	37.8	38.5	45.0	30.0	45.0	36.0	37.1	
	tot %	2.8	2.5	1.4	6.0	7.0	3.2	3.2	3.2	3.2	4.6	36.8
20 - 30%	count	0	3	1	4	10	2	1	2	9	7	39
	row %	0.0	7.7	2.6	10.3	25.6	5.1	2.6	5.1	23.1	17.9	
	col %	0.0	15.0	5.3	8.9	19.2	10.0	3.3	10.0	36.0	20.0	
	tot %	0.0	1.1	0.4	1.4	3.5	0.7	0.4	0.7	3.2	2.5	13.7
30 - 50%	count	0	1	1	2	1	0	1	3	4	2	15
	row %	0.0	6.7	6.7	13.3	6.7	0.0	6.7	20.0	26.7	13.3	
	col %	0.0	5.0	5.3	4.4	1.9	0.0	3.3	15.0	16.0	5.7	
	tot %	0.0	0.4	0.4	0.7	0.4	0.0	0.4	1.1	1.4	0.7	5.3
MORE THAN 50%	count	0	0	0	0	4	0	0	0	1	5	10
	row %	0.0	0.0	0.0	0.0	40.0	0.0	0.0	0.0	10.0	50.0	
	col %	0.0	0.0	0.0	0.0	7.7	0.0	0.0	0.0	4.0	14.3	
	tot %	0.0	0.0	0.0	0.0	1.4	0.0	0.0	0.0	0.4	1.8	3.5
	COLUMN TOTAL	19	20	19	45	52	20	30	20	25	35	285
		6.7	7.0	6.7	15.8	18.2	7.0	10.5	7.0	8.8	12.3	100.0

No. of missing observations = 7

Exhibit 12

DOES YOUR FIRM HAVE A FULL-TIME (SPECIALIZED) FINANCIAL MANAGER?

		Halifax	St. John	Que. City	Montreal	Toronto	Kitchener	Winnipeg	Saskatoon	Calgary	Vancouver	Row Total
YES	count	2	9	2	17	11	8	4	7	8	3	71
	row %	2.8	12.7	2.8	23.9	15.5	11.3	5.6	9.9	11.3	4.2	
	col %	10.5	45.0	10.5	36.2	20.0	40.0	13.3	35.0	30.8	8.6	
	tot %	0.7	3.1	0.7	5.8	3.8	2.7	1.4	2.4	2.7	1.0	24.4
NO	count	17	11	17	30	44	12	26	13	18	32	220
	row %	7.7	5.0	7.7	13.6	20.0	5.5	11.8	5.9	8.2	14.5	
	col %	89.5	55.0	89.5	63.8	80.0	60.0	86.7	65.0	69.2	91.4	
	tot %	5.8	3.8	5.8	10.3	15.1	4.1	8.9	4.5	6.2	11.0	75.6
	COLUMN TOTAL	19 6.5	20 6.9	19 6.5	47 16.2	55 18.9	20 6.9	30 10.3	20 6.9	26 8.9	35 12.0	291 100.0

No. of missing observations = 1

As for growth rates, Exhibit 11 indicates that Kitchener, Winnipeg and Atlantic firms showed the greatest tendency to be negative-growth firms, while Calgary, Saskatoon and Vancouver tended to have firms with growth rates in excess of 30% per annum. The Calgary and Vancouver firms also tended to be younger (see Exhibit 8).

Depth of financial management varies considerably by location. Least likely to have a full-time (specialized) financial manager are firms in Halifax (11%), Quebec City (11%), Winnipeg (13%) and Vancouver (9%); most likely are firms in Kitchener (40%), but again this is probably a function of size and age of the business rather than location alone. As expected Montreal (36%) is more likely than average (24%) but somewhat surprising are the observations that St. John (45%) is much more likely than average and Toronto (20%) slightly less likely than average.

B. Current Financial Policy

Respondents were asked to score the importance of sources of advice on financial policy in the first question in this section. The financial manager did not receive a particularly high average score, no doubt reflecting the fact that only one in four of the respondent firms had one at all. The firm's external (public) accountant and internal sources of advice tended to score highest, though it must be repeated that these tabulations reflect the average answers in the total sample: mean scores may differ substantially among sub-samples that are of concern to public policy makers and NBFIs. It is interesting to note, however, that the public accountant received a higher average score than the firm's banker.

Mismatching maturities was a common problem identified by the MacMillan enquiry into small business financing in Britain over 30 years ago. Apparently, many British firms were using overdrafts at the bank to finance permanent needs for funds. Then, when credit conditions became more stringent, the businesses suffered because they were unable to meet the demands of banks. Though perfect matching is not always possible, we feel that it is certainly a desirable goal, for it decouples the operating and financial decisions open to management to some extent and allows for better long term planning. Firms that match maturities can to some extent cease worrying about renewals of financing and concentrate on their operating objectives in the real (non-financial) sector. Question 2 was designed to determine whether the mismatching problem is widespread in Canada. Four out of ten respondents said that they had used short term financing to meet long term needs. Of these, however, 40% said that it had been merely a temporary measure used while they were awaiting a better time for long term financing. Only 17 respondents (15% of the mismatchers) said that they did so because it was the only type of financing they could get. Fifteen made some other answer. Several respondents said that it was more convenient to use short term financing and one said that he felt that it was a normal business practice. In fact, of the 115 mismatchers, two-thirds said that they found the mismatching policy desirable and only one-third said that they did not. Most of the mismatchers said that they mismatched only occasionally while 20% said they always did it and 24% said they usually did so.

Mismatching varies by location as is evident in Exhibit 13. Centres in which firms tend to mismatch more than average (39%) are St. John (45%), Kitchener (55%), Winnipeg (60%) and Calgary (54%). It might be argued that financial markets in these centres are less well developed than in Toronto, Montreal and Vancouver, but it must be noted that firms in Halifax, Quebec City and Saskatoon mismatched less often than average despite this situation.

Exhibit 13

DO YOU EVER USE SHORT TERM FINANCING TO MEET LONG TERM NEEDS?

		Halifax	St. John	Que. City	Montreal	Toronto	Kitchener	Winnipeg	Saskatoon	Calgary	Vancouver	Row Total
DON'T KNOW	count	0	0	0	0	0	0	1	0	0	1	2
	row %	0.0	0.0	0.0	0.0	0.0	0.0	50.0	0.0	0.0	50.0	
	col %	0.0	0.0	0.0	0.0	0.0	0.0	3.3	0.0	0.0	2.9	
	tot %	0.0	0.0	0.0	0.0	0.0	0.0	0.3	0.0	0.0	0.3	0.7
NO	count	15	11	13	31	35	9	11	14	12	24	175
	row %	8.6	6.3	7.4	17.7	20.0	5.1	6.3	8.0	6.9	13.7	
	col %	78.9	55.0	68.4	66.0	63.6	45.0	36.7	70.0	46.2	68.6	
	tot %	5.2	3.8	4.5	10.7	12.0	3.1	3.8	4.8	4.1	8.2	60.1
YES	count	4	9	6	16	20	11	18	6	14	10	114
	row %	3.5	7.9	5.3	14.0	17.5	9.6	15.8	5.3	12.3	8.8	
	col %	21.1	45.0	31.6	34.0	36.4	55.0	60.0	30.0	53.8	28.6	
	tot %	1.4	3.1	2.1	5.5	6.9	3.8	6.2	2.1	4.8	3.4	39.2
												291
COLUMN TOTAL		19	20	19	47	55	20	30	20	26	35	
		6.5	6.9	6.5	16.2	18.9	6.9	10.3	6.9	8.9	12.0	100.0

No. of missing observations = 1

Search procedure for sources of capital

Question 3 was meant to elicit shopping habits of small businesses in need of financing in Canada. If there is evidence of extensive shopping, then it is difficult to argue that the costs of using financial markets are inordinately high, unless finance is perceived by the firms to be a major problem. Data presented later suggests that it is not. Again it must be mentioned that the statistics reported in Appendix B-5 pertain only to the total sample. Regardless of the results reported here, there may be substantial differences between the shopping habits of subsamples of firms that are of interest to government policy makers or to NBFIs. Analysis of these subsamples is left for Section IV.

(a) Short term shopping habits

Not surprisingly, chartered banks were by far the most popular source of short term funds: 98% of respondents said they would approach the bank for funds. The mean rank of the bank as a source of funds was about 1.

Eighty-four percent of the managers who said that they would approach the bank said that they would do so first. The major competitor was the shareholder loan: 39% of the respondents said that they would approach their shareholders for loans and four-tenths of these said they would approach them first. From the relatively few respondents who said they would approach them, Credit Unions, Financial Corporations and Trust Companies received honourable mention as second choices.

An alternative way to analyze the data in this question is to determine, for each respondent, the **first choice** in the search procedure and to tabulate the frequency distribution of first choices. This is done in Exhibit 14. The same basic pattern of responses is detected, though information on second and subsequent potential sources of supply is lost: 78% of the 292 respondents said they would approach a bank first for short term financing. Fourteen percent would approach their shareholders first. No other source of supply was mentioned as a first choice by more than 1% of the respondents.

Exhibit 14

SHOPPING FOR CAPITAL: INSTITUTIONS AND OTHER SOURCES THAT RESPONDENTS WOULD APPROACH "FIRST"

	Short term		Long term		Equity	
	#	%	#	%	#	%
Chartered Bank	228	78	141	48		
FBDB	N/A	N/A	20	7	15	5
Own shareholders	40	14	31	11	182	62
Friends, relatives	3	1	3	1		
Caisse/Credit Union	2	1	2	1		
Trust Company			25	9		
Financial Corp.	1	0	20	7		
Life Ins/Pension			7	2		
Investment dealer			1	0	4	1
Venture capitalist					2	1
Other	4	1	12	4	12	4
No Answer	14	5	30	10	77	26
Totals	**292**	**100**	**292**	**100**	**292**	**100**

(b) Long term debt and lease shopping habits

Again, the bank was the most popular choice, but not by as wide a margin. Three out of four respondents said they would approach the bank and of these 68% said that they would approach the bank first in searching for long term debt or lease financing. The bank was followed by own shareholders (29%), FBDB (30%), Trust Companies (27%) and Financial Corporations (26%) as alternative sources of supply. There is evidence of substantially more shopping in the long term than in the short term debt market. NBFIs may be interested in breakdowns of the firms that mentioned that they would approach them, and that gave them second ranking, since it may be possible to improve their competitive position in this segment of the market.

It is also interesting to note that FBDB ranks very low on the list of suppliers in this category. Though 30% of the managers said they would approach FBDB, apparently they did not like the idea of doing so: 44% gave FBDB a rank of 3 or more, compared with 7% for banks, 30% for trust companies, 31% for financial corporations and 27% for own shareholders. Of course, it is possible that this ranking reflects that fact that in order to obtain a loan from FBDB, a business must first be unable to obtain private financing on reasonable terms and conditions. However, we feel that this explanation is far from complete because in the following question we observed that FBDB received a low average ranking on a scale meant to capture how well institutions had served small businesses.

The "first choice" analysis in Exhibit 14 reflects these same general attitudes. Though bank loans and shareholders loans still dominate, their dominance over other sources of supply is not nearly as great as it is in the short term segment of the market. In particular, trust companies and financial corporations are apparently viewed as viable sources of supply in this market segment. Since only 48% of firms, at present, would approach a bank first, it appears that there is a lot of room for NBFIs to compete, especially by making inroads into the segments served by FBDB and shareholder loans. It may also be possible for NBFIs to make incursions into the part of the market served by chartered banks.

(c) Shopping for equity

Firms' own shareholders were by far the most significant source of equity funding mentioned by respondents. No doubt, this reflects the desire of small business people to remain independent as we report in a later part of this section. Nearly 70% of the respondents said that they would approach their own shareholders for equity financing and of these virtually all gave this source the top rank. However, from the relatively few respondents that mentioned them, FBDB venture capitalists and investment dealers received quite honourable mention, especially as second choices.

The "first choice" analysis (Exhibit 14) reveals that 62% of respondents would approach their own shareholders first and 5% would approach FBDB first. No other sources of supply would be approached first by more than 1% of the firms in the sample.

(d) Comparison of Shopping Behaviour by Location

Exhibit 15 is an analysis of where small independent businesses would go for funds if they required financing today. It is possible that some types of institutions are better represented than others in certain regions and that firms' awareness of them and willingness to approach them is greater than in other locations.

Exhibit 15 shows that respondents in Quebec City, Winnipeg and Vancouver are somewhat less inclined than others to use banks as a long term source of funds; those in Vancouver also make less use of banks for short term loans. The Winnipeg and Vancouver low bank utilization rates are apparently not offset by higher utilization of other institutional sources of funds. By contrast, Quebec City respondents appear to substitute for bank financing the following sources:

(1) Higher than average utilization of FBDB, both for long term loans and equity.

(2) Much higher use of credit unions (caisses) for both short and long term loans.

(3) Higher than average use of trust companies for long, and financial corporations for short term loans.

Exhibit 15

COMPARISON OF SHOPPING BEHAVIOUR BY LOCATION

		Halifax		St. John		Que. City		Montreal		Toronto		Kitchener		Winnipeg		Saskatoon		Calgary		Vancouver		Whole Sampl
Respondents who would approach:		#	%	#	%	#	%	#	%	#	%	#	%	#	%	#	%	#	%	#	%	%
Bank	short term	19	100	19	95	18	95	44	94	55	100	19	95	29	97	20	100	25	96	30	86	96
	long term	14	74	19	95	13	68	35	74	41	75	18	90	20	67	18	90	21	81	24	69	77
FBDB	long	2	11	8	40	5	26	12	26	18	33	6	30	5	17	11	55	8	31	13	37	30
	equity	2	11	5	25	4	21	6	13	7	13	2	10	2	7	2	20	2	8	4	11	12
Own shareholders	ST	8	42	6	30	10	53	17	36	27	49	9	45	9	30	6	30	8	31	11	31	39
	LT	7	37	6	30	7	37	12	26	19	35	8	40	7	23	3	15	8	31	7	20	29
	EQ	13	68	11	55	13	68	38	81	33	60	14	70	18	60	17	85	17	65	22	63	68
Friends, relatives	ST	2	11	2	10	5	26	6	13	10	18			34	10	4	20	3	12	2	6	13
	LT	1	5	2	10	3	16	4	9	5	9			4	13			3	12	1	3	8
Caisse/Credit Union	ST					4	21	7	15	6	11			3	10	3	15			6	17	10
	LT					5	26	4	9	3	5			3	10	2	10			2	6	7
Trust Company	ST	1	5	2	10	3	16	4	9	7	13	1	5	1	3	7	35	4	15	5	14	12
	LT	6	32	6	30	8	42	8	17	10	18	5	20	4	13	14	70	10	38	10	29	27
Financial Corp.	ST	2	11	3	15	3	16	5	11	6	11	2	10	2	7	3	30	4	15	4	11	12
	LT	8	42	4	20	5	26	14	30	15	27	7	35	3	10	9	45	8	31	4	11	26
Life Ins/Pension	LT only	1	5	1	5	6	32	2	4	5	9	3	15	1	3	3	15	4	15	4	11	10
Investment dealer	LT					2	11			4	7							1	4			2
	EQ					2	11	3	6	5	9			1	3	1	5	2	8			5
Venture capitalist	EQ	1	5	1	5	1	5	6	13	6	11	1	5	2	7	2	10	4	15	3	9	9
No. of potential respondents		19	100	20	100	19	100	47	100	55	100	20	100	30	100	20	100	26	100	35	100	

NB. Columns do not add to 100% because respondents often said they would approach more than one source of supply.

FBDB

FBDB appears to be used more than average in St. John, Quebec City and Saskatoon, but somewhat less than average in Montreal and Winnipeg. Halifax also shows less than average utilization for long term loans but not for equity. The point was made to us at the inception of the study that FBDB was a more important institution in smaller communities, where often it served as the only alternative source of supply to bank branches. This hypothesis is not refuted by Exhibit 15.

Credit Unions

Credit unions (Caisses in Quebec) were not mentioned at all by respondents in 4 of the ten centres (Halifax, St. John, Kitchener and Calgary). In the other 6 cities, they were most popular in Quebec City, followed by Vancouver, Montreal, Saskatoon, Winnipeg and Toronto.

Trust Companies and Financial Corporations

These two institutions are apparently not more popular than average in Toronto and Montreal, where they flourish. In fact, there appears to be above average willingness to approach them in Halifax, Quebec City, Kitchener, Saskatoon and Calgary.

Investment Dealers and Venture Capitalists

Very little mention was made of these institutions as suppliers of long term debt or equity funds. Recall that to be mentioned as a source that a respondent would approach, these intermediaries did not have to qualify as a first choice by any means, so the low level of reported utilization effectively means that it is extremely unlikely that the small firms would ever approach them for funds. Only in Toronto, Montreal and Calgary were they mentioned more than a couple of times during the field work as potential suppliers of capital to small independent businesses.

Conclusions

From the analysis in this section, we conclude that shopping is minimal in the short term end of the market, since the banking industry has captured a major share of this source of funding. Moreover, small business persons are not particularly interested **en masse** in any outside sources of equity financing, reflecting no doubt their desire to be independent: a prime motivating factor in starting a small business in the first place. Though we do not wish to labour the point, we should reiterate that there are exceptions to the rule that are evident in the responses tabulated in the Appendix, which may be of concern to NBFIs. Some analysis of these cases is performed in Section IV.

It appears that if lending institutions other than banks are to make major inroads in financing the small business sector, it must be in the market for long term debt or lease financing. Here, there is evidence that small businesses are willing to shop for capital rather than relying on chartered banks. The precise terms and conditions of such financing, however, are the subjects of future chapters of the study.

There is some evidence of differences in shopping behaviour by location. Again, however, there may be other demographic variables working simultaneously to produce the differences in awareness or utilization by location. Formal statistical tests of utilization of the intermediaries as a function of these variables is left to Section IV of this chapter.

C. FINANCING EXPERIENCE IN THE PAST THREE YEARS

This section of the questionnaire was designed to elicit what experience small businesses had had in actually shopping for financing in the past 3 years. We expected that the answers here would condition the answers to questions in part B on where they would shop for financing in the future and that they would provide us with a profile of where they did shop, regardless of where they said they would shop.

(a) Type of Funding and source of supply

Four episodes of funding were surveyed. Only 12% of the businesses in the sample had shopped for funds 4 times in the past three years, though virtually all had shopped once and 60% had shopped twice or more. The first episode reported tended to be a short term loan from a bank and the second was often a long term loan from a bank. It is interesting to note that leasing was not popular as a source of funds for these businesses, except among those who went to the market three or more times for funding. This may indicate that the shoppers who are well aware of financing opportunities available are more likely to choose leasing and that the opportunity exists for lessors to bring the potential advantages to the attention of firms who have not shopped as frequently.

As noted in Section VI of this chapter, we were interested to note that a fairly popular answer in the "other" category under "type of supplier" was the manufacturer or captive dealer who provided the asset being purchased, such as General Motors Acceptance Corporation or Chrysler Financial Corporation.

An important point to note is that government agencies were hardly ever mentioned as sources of supply; whatever respondents say about such agencies and however aware they are that they exist, they evidently use them very seldom. NBFIs (trust and finance companies) were utilized primarily by firms, in the sample, that had shopped more than once for funds.

(b) Purpose of Financing and Security given to the Supplier of Funds

The first reported episode of financing within the last three years tended to be a short term loan from a bank, as was outlined previously. Usually, the purpose of this loan was to finance working capital items, such as inventories or accounts receivable. It was noted that several respondents expressed resentment at having to borrow to finance receivables, in particular, and one said that the government should assist small businesses in the collection of their receivables. A common complaint that surfaced in our review and edit of the questionnaires was that small businesses were exposed to considerable risk and uncertainty regarding their receivables, yet the banks who often financed them were fully secured by personal guarantees.

Two answers were allowed in describing the security given to the supplier of funds. Generally, short term loans to finance current assets were secured by the assets themselves. As was noted in Section III, answers included assignment of book debts, section 88 or 86 of the Bank Act, inventories and current assets. In addition to this security, a significant number of respondents reported that they gave personal guarantees to the lender in connection with the financing of their current assets.

The second reported episode of financing generally related to the purchase of assets: either movable equipment or land and buildings. Movable equipment tended to be secured by a chattel mortgage or a floating charge on the firm's assets, often in conjunction with a personal guarantee. The third reported episode also tended to be some sort of loan to purchase assets for use in the business, secured by the means mentioned immediately above. Finally, the fourth episode was similar in its general characteristics to 2 and 3, but only 12% of the respondents reported having engaged in four episodes.

Means of security that were seldom reported, but which nevertheless were mentioned occasionally, were shares of the firm and cash surrender value of the manager's life insurance. Evidently, lenders are not inclined to accept the firms' shares as collateral for loans or perhaps borrowers loath to proffer them. Furthermore, very few respondents reported being able to secure financing with a floating charge on their general business assets. Apparently, lenders on the average prefer to be able to look to specific assets of small independent businesses in order to satisfy their claims in the event of financial difficulty on the part of the borrower.

(c) General rating of institutions by small businesses

Question 2 was designed to elicit the respondents' impressions of how well the institutions they had dealt with, in the previous question, generally served their financing needs. It is clear from the responses that on the average, the institutions were viewed as performing quite well. It is notable that only 8% to 17% of the ratings of any institution were below 4 on the semantic differential scale, where 4 was defined to be adequate service.

It bears repeating that the institutions, taken as a whole had an enviable record with regard to how well they had served their customers in the small business sector. In Section IV, analysis will be made of the small subsample of firms and episodes of financing in which institutions were rated as less than adequate.

One hundred and seventy subjects used question 2(b) to elaborate on the answers that they had made in (a). A representative listing of such comments in this area are noted in Section VI of this report. Thirty-seven percent of the subjects who responded to the question gave comments that were postcoded as favourable and 42% made comments that we viewed as unfavourable. Most of the unfavourable comments were specific complaints, however, which did not detract unduly from the generally high rating given to the institution on the semantic differential scale. There can be little doubt that even in cases where service is good, there are always opportunities for suppliers of capital to improve their service to their customers. Lenders may wish to consider the comments in Section III and decide whether the costs of potentially rectifying the negative comments are outweighed by the benefits that might accrue to them.

(d) General description of financing experience

Question 3 asked for the subject's impression of the ease, in general, with which financing had been obtained in the past. It is extremely important to note that only 1 in 4 of the respondents said that they had not **always** been able to obtain **as much or more** financing than they applied for. This, in conjunction with the generally high ratings given the institutions in the previous question, implies that the market for small business financing is functioning reasonably well. Nonetheless, public policymakers will no doubt be interested in the minority of businesses that stated that they did **not** always get as much or more than they applied for. The analysis of this subsample of firms is in Section IV.

(e) More on Shopping Behaviour and on the Factors Important in Financing

Questions 4 to 7 asked for information on situations in which the businesses had voluntarily turned down firm offers of financing from various sources of supply and for information concerning the factors that **would** be important in deciding whether to turn down an offer of financing in various categories. Note that this latter question was hypothetical, so almost all subjects answered it whether they had actually rejected offers of financing or not.

Exhibit 16 summarizes data on the actual reported rejections. It is evident that more rejections are reported in the categories, short term debt,

Exhibit 16

SUMMARY DATA ON REJECTIONS OF OFFERS OF FINANCING BY THE SUBJECTS (PAST 3 YEARS)

	Short Term	Long Term	Lease	Equity
No. who had rejected	58	48	39	34
No. who had rejected more than one	22	19	19	15
No. who rejected because best offer not tolerable	9	10	11	4

long term debt and equity respectively. Either the respondents were more discriminating with regard to the first mentioned categories, or the supply of funds in those categories was greater, or both. We were interested to note that a fifth of the subjects had turned down short term financing (the greatest number of rejections) and one-twelfth had rejected equity financing (the least number of rejections). Moreover, only 9, 10, 11 and 4 respondents (3%, 3%, 3% and 1%) in the aforementioned categories stated that they rejected the offer because the best offer by the supplier of funds was not tolerable. Though one must be careful not to jump to conclusions here, the evidence seems fairly convincing that more of the rejections reflected discrimination on the part of the borrower rather than frustration of his or her objectives.

Exhibit 17 summarizes the mean and median scores of factors that would be important to the subjects in deciding whether to turn down a firm offer of financing in the four categories. We caution the reader at this point that one must be careful in interpreting the mean values of ratings for which there is no absolute zero measure: a 5 on a scale from one to seven may mean different things to different respondents or in different categories of financing. Thus, for example, it is **not appropriate** to compare a score of 6 for the importance of interest rates to one respondent with the analogous score of 4 for another respondent, then assert that the interest rate was a more important factor for the first respondent than for the second. However, within a category of financing the mean and median scores provide a useful summary of the central tendency of the respondents' answers. Even within a category, it is not appropriate to compare a score of 6 with a score of 3, then to assert that the factor that received the score of 6 was "twice as important." It can only be said that on the average the respondents found the factor with the mean score of 6 to be **more important**

Exhibit 17

MEAN AND MEDIAN SCORES OF FACTORS THAT RESPONDENTS SAID THAT THEY WOULD CONSIDER IN DECIDING WHETHER OR NOT TO REJECT OFFERS OF FINANCING IN FOUR CATEGORIES

TYPE OF FINANCING

FACTORS	Loans: Short Term		Loans: Long Term		Lease		Equity	
	Mean	Median	Mean	Median	Mean	Median	Mean	Median
Interest rate too high	5.9	7	6.1	7	6.1[1]	7		
Not enough funds offered	4.6	5	4.9	5			5.1[2]	6
Too much collateral req'd	4.8	5	4.9	5				
Repay. sched. too rapid	4.1	4	4.5	5				
Covenants too restrictive	4.5	5	4.5	5	4.7	5		
Personal guarantee required	4.5	5	4.6	5	4.7	6		
Lessor participation clause unsuitable					4.5	5		
Cancellation terms too severe					5.0	5		
Lease not long enough					4.5	5		
Rental payments too high					5.9	7		
Control of operat'ns via voting shares							6.5	7
Price per share too low							6.0	7
Suitability of buy-back agreement							5.2	6

SCORE:
1 = unimportant
4 = fairly important
7 = extremely important

Notes
1 Specific category on questionnaire was "implicit interest rate too high."
2 Specific category was "amount of financing available."

than that with the mean score of 3. Even then, we caution that the reader really ought to look at the raw frequency distributions for questions 4 to 7 in Appendix B-5, since for many, the distributions had interesting shapes that were not captured in the mean or median scores alone.

Notwithstanding the caveats above, it is clear from Exhibit 17 that on average, interest rates are unquestionably the most important factor considered by small business people in the sample for debt and leases. In the equity market, control of the firms' operations through voting shares seems to be paramount. Thus, the proverbial small business problem alluded to in the finance texts, raises its head in our survey too: They do not want to pay high interest rates on senior securities, but neither do they want to give up control of the business by selling voting shares to the public. Obviously, if financing becomes a problem for these businesses, some compromises will have to be made. However, so far no convincing evidence has been adduced in this chapter to indicate that financing generally **is** a problem in this sector.

Since lenders and lessors individually can do little about the level of interest rates in a competitive market for funds, perhaps they should focus on other factors of importance to small businesses if they wish to develop a distinctive competence in lending to this sector. Unfortunately, we are unable to identify factors of obviously greater importance than others, in this regard. Nonetheless, further analysis may indicate that there are identifiable factors of primary importance in various subsamples of the sample and NBFIs and policymakers may wish to focus on these subsamples. This analysis will be performed in Section IV.

It should be mentioned that in all categories, personal guarantees and other collateral turned up as bones of contention. In our qualitative review of verbatim responses in Section VI, these factors were the subjects of numerous complaints by the business people. Finally, some of the frequency distributions in Appendix B-5 are quite clearly bimodal. In the short term lending area, for example, the personal guarantee is ranked as extremely important by 38% of the respondents, but it is also ranked as unimportant by 11%. We would expect that this latter group is composed of larger firms who do not have to give personal guarantees and that the former group is comprised of smaller firms whose financial managers or owners are required to do so. Even if such subsamples can be identified in future work, however, it is not clear what can be done to satisfy the concerns of the respondents. Arguably, personal guarantees are required because the businesses have incorporated and because without the guarantees financing would be nearly non-existent in this sector.

It seems clear that all four types of financing are fundamentally best viewed as bundles of attributes, rather than as entities unto themselves. The relative importance of interest rates found in the study may reflect in part the fact that at the time of the survey interest rates in Canada were at the highest level in the country's history. It is possible that after the business people become accustomed to such rates, this factor will be relatively less important.

(f) Rejections on the supply side

Question 8 of the questionnaire asked for the past three episodes in which a lender or other supplier of funds had turned down the respondent's request for funding. Appendix B-5 shows that about 14% of the subjects had been turned down once and 5% twice, almost always by banks. Almost never did the subjects disagree with the reason given by the supplier and more than half the time they found financing elsewhere.

Once again, it seems that on the average borrowers are not having difficulty obtaining the financing they desire, though there are evidently a few hard cases buried in the data in Appendix B-5 whose analysis must wait until Section IV.

(g) Related services - very little interest

Question 9 is directed at the extent to which small businesses might use various ancillary services provided by financial institutions and the extent to which they use such services now. The subjects at present report having used mainly the credit enquiry services and payroll services of banks. The areas for growth appear to be data processing, cash flow planning and accounting packages, with still more use being made of payroll facilities. Since banks are proscribed by law from offering management advisory services, it appears that other NBFIs may have particularly important roles to play in these areas.

Question 9(b) asks whether the respondents would be interested in purchasing a package of moderate-cost personal financial advisory services for their employees. Though 15% of the respondents said yes, virtually none of them would be willing to sacrifice any of their existing benefits for these services. Evidently such concerns are not given high priority by the respondents.

D. FUTURE FINANCING PLANS

Question 1, in this section of the questionnaire, asks whether the firm has on hand a budget of financing needs over the next year or more. Forty-two percent (123) of the firms sampled said that they did. Usually, the budget covered only one year, but occasionally it covered as much as 5 years (14% of respondents who had a budget reported that it covered 5 years or more). For the 123 firms that had a budget, about half the time it was prepared by a full time financial manager, though in a few cases the budget was prepared by the financial manager in concert with a "management team."

The next part of the question asked the subject to rate the chances of his or her firm obtaining the funds required in the budget on acceptable terms. The frequency distributions in Appendix B-5 show that this subsample of budgeters foresaw little difficulty on average in obtaining the funds they required, though there are once again a few hard cases buried in the data.

When the budgeters who will not need financing over the budget term are removed from the sample, it is evident that respondents differed substantially in their assessment of the likelihood of obtaining the required funds from different sources.

Respondents were evidently much less certain of obtaining long term than short term funding, particularly in the equity markets. The percentages of respondents who felt that their chances of obtaining the required financing was 50% or less in the three categories were as follows:

Short term debt	14%	(13 firms)
Long term debt	20%	(14 firms)
Equity	33%	(10 firms)

It should be emphasized here that, though the percentages differ, overall very few firms were pessimistic about obtaining financing in the three categories.

Relative frequencies of answers for budgeting firms that will require financing in the three categories

	Category	**Short (%)**	**Long (%)**	**Equity (%)**
1	Virtually certain	75	60	50
2		8	13	13
3		3	7	4
4	50:50 chance	8	10	16
5		0	0	4
6		2	4	0
7	Most unlikely	4	6	13
		100	**100**	**100**
Relevant no. of respondents		**110**	**83**	**37**

Next, question 2 asked what difficulties the firm would face if it were unable to obtain the financing called for in the budget. The most common response was that the business' growth would suffer or that expansion would have to be curtailed. Very few of the budgeters appeared to be worried about bankruptcy or insolvency. Other answers that appeared relatively frequently were that the firm would have to interrupt its production or delivery schedules or lay off workers temporarily.

Question 3 was designed for the non-budgeters, who were in the majority in our sample. The tabulations in Appendix B-5 indicate that among this subsample of firms, 24% felt that there was a 50:50 chance or less of obtaining the financing they required on acceptable terms over the next three years and nearly 60% were virtually certain that they would obtain it. We are unable to identify any significant difference between the budgeters and non-budgeters regarding their perceptions of the likelihood of their firms' obtaining the needed financing over the 3 year horizon.

Objectives for the business

The fourth question attempted to elicit the relative importance of various objectives as stated or implied by the principal owners or managers of the business. The problems faced by small businesses are no doubt conditioned by the goals of the key players. For instance, the lack of financing problems noted so far in this chapter **could** be due to "voluntary capital rationing." If the small business' managers or owners wish to spend afternoons on the tennis courts or the golf course, then they are less likely to be concerned with the lack of financing to support growth or expansion of their firms.

Our findings indicate that on the average the small business people are not inclined to sacrifice growth and profitability for leisure time. The ranking of objectives by mean and median scores was as follows (the reader is referred to the discussion above on the significance of means of scales with only weak interval properties):

	Mean	Median	Standard Deviation
Maintain control & independence	6.2	6.7	1.4
Increase profits	6.1	6.6	1.1
Increase operating efficiency	5.8	6.3	1.4
Growth in sales	5.8	6.2	1.5
Have stable income & life style with some sacrifice.....	4.3	4.5	2.1
Be a good corporate citizen	4.2	4.3	2.0
Refinance	2.3	1.4	1.8
Sell out	2.2	1.4	1.8

Again, the reader is referred to Appendix B-5 for an actual tabulation of the subjects' responses. The means reported above mask some interesting characteristics of the distributions. The top four factors were given scores of 7 by nearly half of the respondents. Almost none of them ranked these objectives as less than moderately important. The life style objective, on the other hand, exhibited a bimodal distribution, with about half of the respondents giving it 4 or less, but 37% giving it 6 or 7. Thus, there may be a significant subsample of firms for which the voluntary capital rationing hypothesis holds. This awaits further analysis in Section IV.

To summarize, we are unable to say without further analysis how important voluntary capital rationing is in the small business sector or how it correlates with other variables of interest. We can report with considerable confidence, however, that the respondents in the sample were almost unanimous in their desire for independence, growth in sales and profits and increase in operating efficiency. From this, we infer that generally severe lack of financing, if it ever occurred, would prevent the businesses in the sample from growing and contributing to the country's economy, since the firms in this sector appear to be quite competitive and aggressive in their stated objectives.

Quite logically, the small business person's desire to maintain control and independence is reflected in the answers to question 5, which asks for the percentage of the firms' voting shares held by the public. Only seven of the firms in the sample had any shares in the hands of the public. These two questions taken together imply that small businesses may not be particularly grateful for assistance in obtaining external equity financing, if such financing entails any sacrifice of control of independence. On the other hand, such reluctance to give up control may be incompatible with their growth objectives, so some compromise may be required.

The relative importance of problems facing the business:

Question 6 requested subjects to score the relative importance of various problems facing their businesses with a score of 1 defined as least important and 7 most important. As the tabulation in appendix B-5 makes clear, there were substantial differences of opinion as to the relative importance of some of the factors. For example, "production" exhibited a strongly bimodal distribution, no doubt reflecting the fact that only 20% of the respondents were manufacturers (see Exhibit 4). There are quite obviously subsamples of firms for which several of the problems are acute, even though they are not given a high mean score by all of the respondents generally.

Bearing in mind the limitations of focusing only on mean or median scores, we report them here as a way of summarizing the distributions and refer the reader to Appendix B-5 for the interesting detail of the responses.

Financing ranked behind five problems arising in the real (non-financial) sector on the average. Apparently, small business people **on the**

Factor	**Mean**	**Median**	**Standard Deviation**
Marketing	5.1	6.0	2.2
Cost controls, current asset mgt.	5.1	5.9	2.1
Inflation	5.0	5.4	1.9
Personnel, skilled help availability	5.1	5.7	2.0
Production	4.6	5.1	2.3
Personal taxes	4.2	4.2	2.1
Financing cost, terms, availability	4.2	4.3	2.2
Corporate taxes	4.1	4.0	2.1
Government red tape	4.1	4.0	2.1
Unreliable services (e.g. postal)	3.7	3.5	2.1
Professional services (lawyers, acct's)	3.6	3.4	2.0
Labour relations (laws, stnd's, unions)	3.2	2.5	2.2

average face more pressing concerns than the lack of financing. Coupled with the absence to this point of evidence indicating widespread financing problems in the small business sector, this implies that the market for financing is operating reasonably well and that further action by governments would have to be considered in relation to other means of assisting small business that the businesses themselves apparently hold in higher priority. Justification for further action would surely have to be based on the explicit objective of assisting a small subsample of businesses which reports that financing is "most important," which has profitability, efficiency and growth as major objectives, which is soundly managed, and which reports that it is unable to obtain the financing it needs. Though the explicit identification of this subsample must await analysis in Section IV, it seems safe to infer from the analysis so far that this is probably an extremely small subsample of firms.

A Note of the Significance of Factor Scores and Objectives Scores:

Though its content is important, this short note may be skipped without loss of continuity. Its objective is to assess the statistical validity of our findings in the two preceding sections.

The foregoing discussion implies that finance is given lower-level priority as a problem facing small business, outranked by marketing, inflation, personnel and cost controls. Production, too, outranks finance though not by as wide a margin. Later in the chapter (part J - 2 of Section IV), it will be shown that (as expected), production was considered especially important by firms in the manufacturing sector. Since not all of the firms are manufacturers, the importance of production is understated in the average scores reported above. This clearly establishes finance as a second order problem for small businesses.

In order to obtain some idea of the significance of this result, confidence intervals were computed for the mean scores reported above. To do this, we simply calculated standard errors for the means, then computed 95% confidence intervals as plus or minus two standard errors. There is a 95% probability that the true means in the population of small businesses lie within this range.

The confidence intervals computed are shown and graphed in Figure 1. When allowance is made for the understatement in the importance of production because only 22% of respondents were manufacturers, it becomes apparent that finance is easily outdistanced by more important problems.

Another way of showing the significance of these results is to compute the level of significance of **differences** in the mean scores. The variance of the difference in the population is the sum of the variances in the scores themselves. Since we do not know the variance in the population, we estimate the standard error of the difference in sample means with sample data. As an example, let us compare marketing with finance. The null hypothesis will be that the mean scores for marketing and finance are equal in the population; the alternate hypothesis will be that marketing has a significantly higher mean score than finance in the population. Thus a onetailed test will be performed.

First, we compute an estimate, $\hat{\sigma}$ of the standard error of the difference in sample means:

$$\hat{\sigma} = \sqrt{\frac{n_1 s_1^2 + n_2 s_2^2}{n_1 + n_2 - 2}} \quad \sqrt{\frac{n_1 + n_2}{n_1 n_2}}$$

$$= \sqrt{\frac{290 \times 4.675 + 289 \times 4.762}{290 + 289 - 2}} \quad \sqrt{\frac{290 + 289}{290 \times 289}}$$

$$= 2.186 \times .0831$$

$$= .1817$$

Next, we compute a t - statistic for the difference between sample means, as follows:

$$t = \frac{\bar{x}_1 - \bar{x}_2}{\hat{\sigma}} \qquad = \frac{5.131 - 4.173}{.1817}$$

$$= \frac{.958}{.182}$$

$$= 5.26$$

The probability of the t - statistic's being 3.29 or higher if marketing did not have a higher mean score than finance in the population is 1 in 2,000. The chances of t being 5.26 or more are even slimmer. Therefore, we reject the null hypothesis -very convincingly- and conclude the marketing has a higher average importance rating than finance in the population.

Figure 1

95% CONFIDENCE INTERVALS FOR MEANS OF SCORES FOR PROBLEMS
FACED BY SMALL BUSINESS PEOPLE

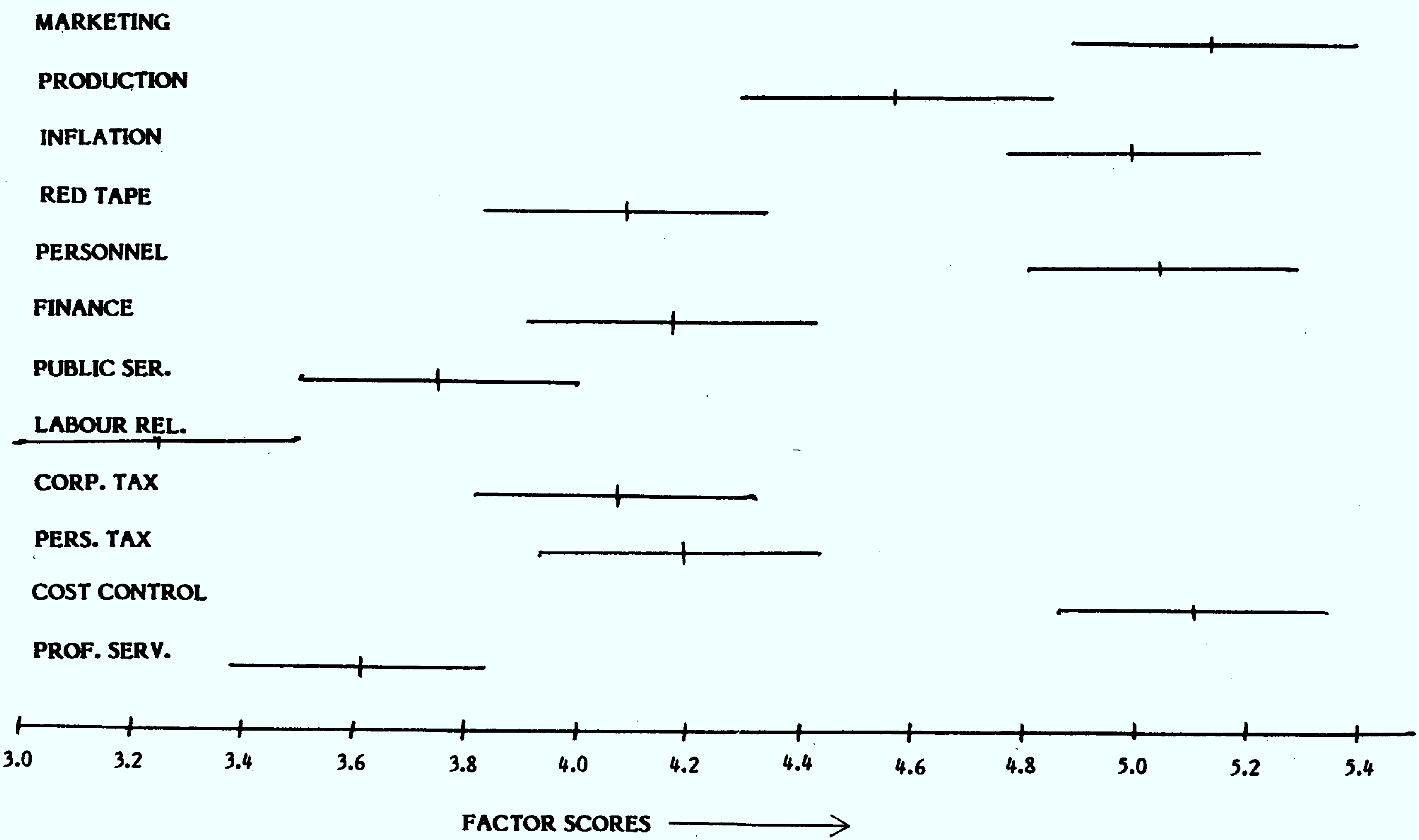


Figure 1 (continued)

STATISTICS ON SCORES OF IMPORTANCE FOR PROBLEMS FACED BY BUSINESSMEN

Factor	x	s^2	n	St. error of mean $\hat{\sigma}_{\bar{x}} = \frac{s}{\sqrt{n-1}}$	95% confidence interval
Marketing	5.131	4.675	290	0.127	4.88 - 5.39
Production	4.566	5.133	265	0.139	4.29 - 4.85
Inflation	4.993	3.571	290	0.111	4.77 - 5.22
Red tape	4.085	4.586	284	0.127	3.83 - 4.34
Personnel	5.052	4.126	288	0.120	4.81 - 5.29
Financing	4.173	4.762	289	0.129	3.91 - 4.43
Public Services	3.747	4.406	288	0.124	3.50 - 4.00
Labour Relations	3.244	4.800	287	0.130	2.99 - 3.50
Corp. taxes	4.073	4.425	287	0.124	3.82 - 4.32
Peronal taxes	4.185	4.622	286	0.127	3.93 - 4.44
Cost controls	5.104	4.240	288	0.122	4.86 - 5.35
Prof. services	3.610	3.784	287	0.115	3.38 - 3.84

Similar results are obtained when finance is compared with inflation, personnel, production and cost controls. Of course, this is intuitively obvious upon examination of figure 1. The relatively low level of importance given to finance is one of the most important findings in the demand-side part of this study.

Similar computations were done to assess the significance of differences in mean scores given to objectives by the respondents. These differences were even more significant than the highly significant differences reported above for the mean scores given to problems facing small business people.

The results are summarized in figure 2. A glance at the figure will show that there can be no doubt that, on average, the small business sector is composed of individuals who want their firms to grow, to be efficient in their operations, and to be profitable without sacrificing independence.

Figure 2

95% CONFIDENCE INTERVALS FOR IMPORTANCE OF OBJECTIVES OF SMALL BUSINESS PEOPLE

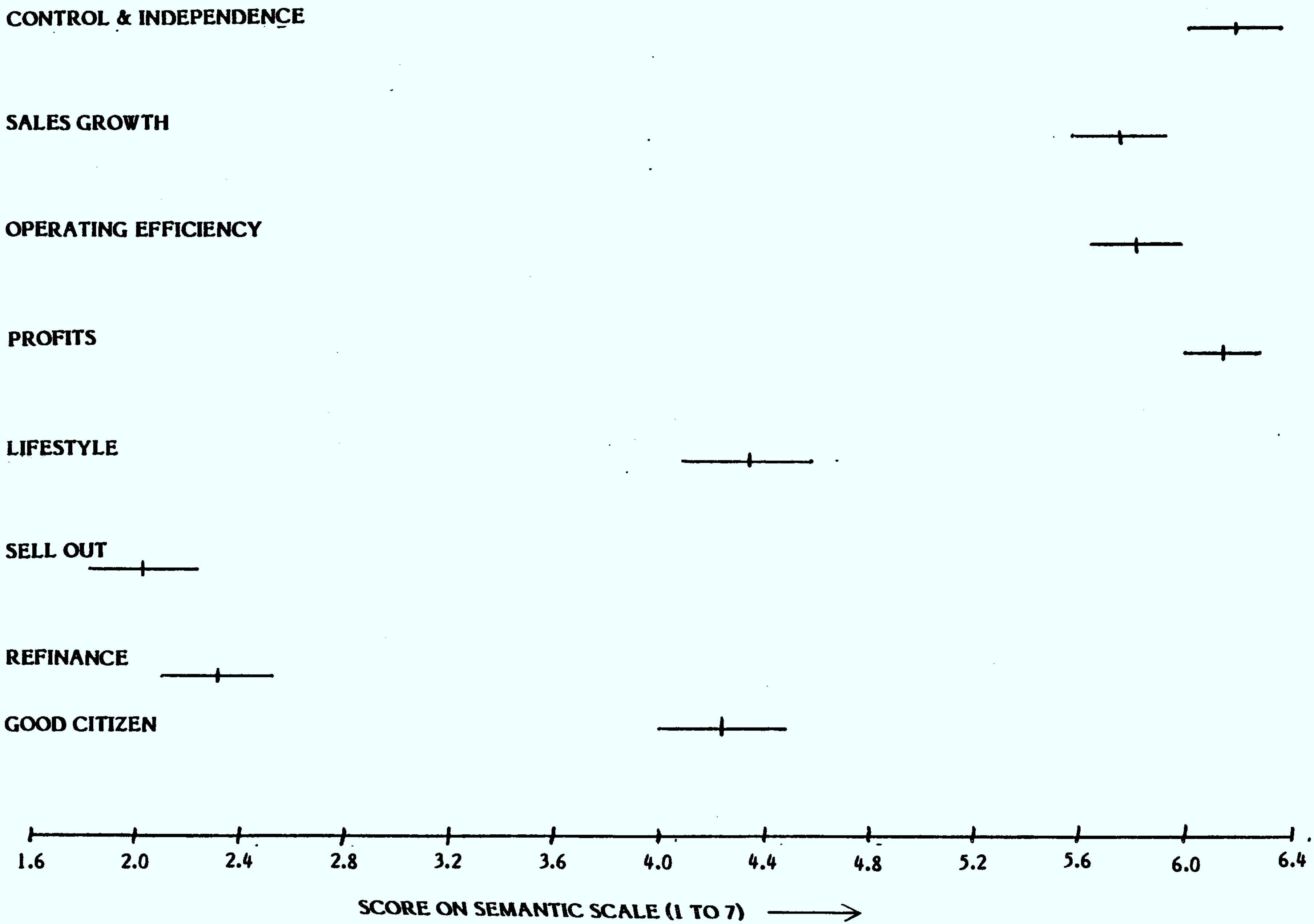


Figure 2 (continued)

Objective	**x**	**s^2**	**n**	**St. error of mean**	**95% confidence interval**
Control & indep.	6.186	2.083	291	.085	6.356-6.016
Sales growth	5.750	2.181	292	.087	5.923-5.577
Operating efficiency	5.810	2.071	289	.085	5.980-5.640
Increase profits	6.137	1.431	292	.070	6.277-5.997
Stable income, some sacrifice	4.336	4.430	292	.123	4.583-4.089
Sell out	2.020	3.124	292	.104	2.227-1.813
Refinance	2.308	3.168	286	.105	2.519-2.097
Good citizen	4.241	4.032	278	.121	4.482-4.000

What makes the finding so significant is that these objectives scores were not assigned arbitrarily, but **in comparison with competing objectives,** whose means were as much as twenty standard deviations lower!

E. AWARENESS OF GOVERNMENT PROGRAMS

In the final section of the questionnaire, subjects were asked to mention the federal and provincial financing or other assistance programmes of which they were aware.

We do not feel that we are able to say much about the awareness or use made of provincial programs, since the answers varied greatly with location; different provinces have different programs in place to accomplish specific regional objectives. We noted 138 answers in total in the lines of the questionnaire asking the subject to list provincial programs of which he or she was aware. Of these 23 did not know whether or not they were eligible for assistance. There were 69 approaches made and of these only 6 resulted in the subject's being turned down for funds.

The subjects appeared to be much more aware of federal programs (exhibit 18). In total 379 answers were recorded, nearly triple the number of answers in the provincial section (of course, some subjects mentioned more than one program in each section). Of these, FBDB was by far the most popular answer. There is some danger here, however, that by this time subjects had already been sensitized to FBDB because it had been mentioned earlier in the questionnaire and possibly even discussed with the interviewer. Nonetheless, 360 of the answers were followed up by the subjects' answering either yes or no to whether they were eligible for assistance from the mentioned federal agency. This would imply that the respondents indeed were aware of the agency and what it did. As for contaçt with the agencies, however, only half of the awareness answers were followed up by approach or use of the agency's services. From this it might be inferred that for the subjects who answered this question at all, awareness of federal assistance programs was somewhat greater than provincial ones, but that the use made of the agencies was about the same, given this awareness.

We find it curious and interesting to note that though 261 answers to the federal aid section of this question indicated that subjects believed they were **eligible** for aid, only 131 had actually made use of the assistance. One explanation for this would be that the sentiment, "the cost of the red tape is not outweighed by the value of the subsidy," is more widely held than was explicitly indicated in the verbatim responses. (See Section VI). It is also interesting to note that of the 193 contacts made with federal agencies, only 17 resulted in the respondent's being turned down in his or her application for assistance. Though it is perhaps dangerous to speculate on the implications of these findings, it seems reasonable to conclude that there is under-utilization of federal assistance programs by the small business sector, given that assistance is available at all. This would be unfortunate indeed, for, as we argued in section I, the primary justification for government action is that it may facilitate transactions that are costly to consummate in a normal market setting. If the perceived cost of using the government assistance programmes discourages their use by small businesses, then the current form of intervention is extremely hard to justify on any efficiency grounds. In fact, even if "equity" (fairness) arguments are used to justify the intervention, such aid cannot be justified if its cost is too high to encourage its use.

Exhibit 18

AWARENESS OF FEDERAL PROGRAMS

Program	**Total no. of times mentioned**
FBDB, CASE	118
SBLA (Small Business Loans Act)	9
SBDB (Small Business Dev. Bond)	35
EDP, EDB, PAIT (Enterprise Dev.)	13
ETC (Employment Tax Credit)	31
EDC (Export Development Corp.)	18
DREE	43
Manpower	51
Other	61
Total	**379**

Eligibility: Total number of answers

Yes	261
No	64
Don't know	35
Total	**360**

Contact with government agencies:

Total number of answers

Approached	45
Used	131
Turned down by	17
Total	**193**

It probably bears repeating here that the costs we refer to are primarily opportunity costs to the small business persons; while they are searching for financing or looking for aid, they could be implementing their strategies and objectives for growth in the real sector. It would be quite rationale for such a person to ignore a financing subsidy if the decrease in profits during the application process exceeded the perceived value of the subsidy. This situation would seem to be particularly possible for businesses that do not have a full time financial manager with the time to devote to the application processes.

The third and final question in this section asked for the respondent's opinion as to the role Canadian governments should play in assisting small businesses generally. A representative list of answers is given in section VI at the end of the chapter. Careful reading and editing of the first 120 questionnaires returned to us indicated that a useful way of characterizing the answers was to indicate via postcoding whether the subject was in favour of more or less government action. The responses to all 292 questionnaires were then were classfied as follows:

Answer Category	**No.**	**%**
More action	142	51
Less action	82	30
Ambivalent (more in some areas, less in others)	53	19
No answer	15	Adjusted*
	219	**100**

*Not included in percentage computations

Possibly, a respondent's attitude toward the role of governments can influence the extent to which he or she uses government assistance.

IV. ANALYSIS

This section of the chapter is devoted to the analysis of specific research questions. Eleven explanatory (independent) variables are used to develop multivariate discriminant functions to answer such questions as: "What are the characteristics of firms who have had difficulty in obtaining financing in the past? What kinds of firms would approach FBDB? What kinds of firms reported dissatisfaction with various kinds of financial institutions?" The strength of a multivariate technique is that each of the explanatory variables is allowed to enter the analysis and to explain all that it can, **given** that other important variables have explained all that they can. For instance, perhaps larger firms would report more satisfaction than small ones with regard to financing experience in the past, but larger firms also tend to have full-time financial managers. Is their reported satisfaction due to size, the presence of the full-time manager, or both? Only a multivariate technique will allow an answer to that question, since the marginal effect of each variable in the presence of the other can be analysed.

Discriminant functions can provide useful information as to which independent variables are important discriminators, even if the theoretical assumptions underlying the use of discriminant analysis are not strictly adhered to for all of the independent variables. (See S.J. Press and S. Wilson, "Choosing Between Logistic Regression and Discriminant Analysis", Journal of the American Statistical Association 73 (December 1978), pp. 699-705, and S.J. Press, Applied Multivariate Analysis, for lucid discussions of these issues.)

Part A of this section describes the eleven explanatory variables and examines some key relationships among the variables themselves. Subsequent parts of this section then report on the results of the multivariate analyses, using these redefined variables.

A. THE EXPLANATORY VARIABLES

X_1 **Industry:** This variable was derived from the primary SIC code of the respondent. It takes the value 1 if the respondent is a manufacturer and 0 if the respondent is in an industry other than manufacturing. Our initial analysis of breakdowns indicated that manufacturers differed from non-manufacturers along a number of dimensions. The variable, X_1, is then a so called "dummy variable." The zero-one method of coding has the advantage that the average value of X_1 for any particular group of respondents is also the proportion of respondents in that group who are manufacturers.

X_2 **Sales, per D&B:** This variable was taken directly from the data on the questionnaire. During the postcoding and editing process, it was noted that this number was always in the range of sales reported by the respondent himself. The assumption in multivariate discriminant analysis is that the explanatory variables are normally distributed. In practice, statisticians have shown that the technique appears to be robust with regard to this assumption, but it was felt that wherever possible, the explanatory variables ought to be defined so that the normality assumption was adhered to as closely as possible. As long as one or more of the explanatory variables are reasonably close to being normally distributed, it is permissible to introduce dummy variables such as X_1, which are not.

X_3 **Assets per respondent:** There were 7 categories checked by respondents for total assets. To use the category numbers themselves in multivariate analysis would violate the normality assumption and provide a variable for which the difference between numbers reported by the respondent had no precise mathematical meaning: i.e., the difference between a 6 and a 7 does not mean the same thing as the difference between a 5 and a 6. (Technically, it is only an ordinal scale, like a person's score for a round of golf, rather than an interval scale such as temperature). Therefore, mathematical operations on the category numbers such as addition, subtraction, multiplication, etc. and others required in multivariate discriminant analysis would not be meaningful.

To rectify this problem, we made numerous assumptions about the median values of assets in each of the seven categories and computed mean assets for all 292 respondents, given each set of assumptions. Finally, we arrived at the following "reasonable" approximations for the dollar value of assets in each of the categories.

Category	Value assigned to assets
1	\$75,000
2	\$150,000
3	\$250,000
4	\$600,000
5	\$2,000,000
6	\$10,000,000
7	\$30,000,000

That is, whenever a respondent reported assets in category 3 (\$200,000 - \$500,000), we assigned the value \$250,000 as being representative of the average respondent in that category. This allowed us to use X_3 as a valid explanatory variable with interval properties, though the assumption of normality is not strictly adhered to.

X_4 **Age of business:** This variable was defined simply as 1981 minus the startup date of the business as reported by the respondent.

X_5 **Export (dummy):** This explanatory variable takes the value 1 if the respondent is an exporter and 0 if not. Recall that this method of coding implies that the mean value of X_5 for a particular group of respondents is also the proportion of respondents in that group who are exporters.

X_6 **Scope (dummy):** Coding here was 0 if the respondent was merely a local distributor and 1 if he was more than local in scope, i.e., provincial to national.

X_7 **Growth rate:** Again, respondents merely checked a range for growth rate per annum in sales. To obtain a scale with more than ordinal properties we assigned the following values for X_7 to each of the categories, representing the midpoint of the range reported:

Category checked	Value assigned to growth rate
1	-0.05
2	0.05
3	0.15
4	0.25
5	0.40
6	0.60

A_6 **Number of full time employees, per respondent:** No recoding was used here. Recall that in section III it was reported that number of employees per D&B was virtually the same on average as the number reported by the respondent.

Exhibit 19
X_2 SALES, per Dun & Bradstreet

ANALYSIS OF VARIANCE

VARIABLE	CODE	VALUE LABEL	SUM	MEAN	STD.DEV.	SUM OF SQUARES	
CITY	2.	HALIFAX	29635999.0000	1559789.4211	2661183.5324	-	(19)
CITY	4.	ST. JOHN	24259000.0000	1212950.0000	1513768.1278	-	(20)
CITY	5.	QUEBEC CITY	37921000.0000	1995842.1053	2952450.5126	-	(19)
CITY	7.	MONTREAL	90090999.0000	1916829.7660	2394807.1742	-	(47)
CITY	10.	TORONTO	71951000.0000	1332425.9259	1751295.9794	-	(54)
CITY	11.	KITCHENER	45748999.0000	2287449.9500	2484499.2668	-	(20)
CITY	13.	WINNIPEG	63613998.0000	2120466.6000	2742421.9094	-	(30)
CITY	14.	SASKATOON	47256999.0000	2362849.9500	2527509.2719	-	(20)
CITY	15.	CALGARY	46175999.0000	1847039.9600	2216266.1416	-	(25)
CITY	16.	VANCOUVER	44457000.0000	1307558.8235	1537388.5018	-	(34)
		WITHIN GROUPS TOTAL	501110993.0000	1739968.7257	2249646.1890	-	(288)

ANALYSIS OF VARIANCE

SOURCE	SUM OF SQUARES	D.F.	MEAN SQUARE	F	SIG.
BETWEEN GROUPS	-	9	-	0.935	0.4948
WITHIN GROUPS	-	278	-		

ETA = 0.1714 ETA SQUARED = 0.0294

X_8 Financial management depth (dummy): This dummy takes the value 1 if the firm has a full time financial manager, and zero if not.

X_9 Financial management training (dummy): Takes the value 1 if the person who manages the firm's finances has a formal designation in accounting or finance, and 0 if not.

X_{10} Location (dummy): Takes the value 1 if the respondent is located near one of the "big four" financial centres (Toronto, Montreal, Vancouver or Calgary) and 0, if not. (i.e., Kitchener, Saskatoon, Halifax, St. John, Quebec City or Winnipeg).

Before using these variables in multivariate discriminant analysis to answer specific research questions, some analysis of the variables themselves and their interrelationships is now presented.

In exhibits 19 and 20, a one way analysis of variance (ANOVA) is performed on sales and age of business by city. Though the means for sales by city do not differ significantly (.49 level of significance), the means of age of business by city do (.0004 level), with Calgary and Vancouver reporting younger businesses and Kitchener and St. John older than average.

Exhibit 21 shows that the universe proportion of manufacturers is not independent of location (chi-square significant at .007 level). Though the chi-square statistic does not test for a specific form of interrelationship, it appears that there is some tendency for the "big four" cities to have a higher proportion of manufacturers than the others. Exhibit 22 shows that the same may be said of exporters. Scope, on the other hand, seems to be independent of whether the respondent is located near one of the big four cities (see exhibit 23).

Exhibit 20

X_4 AGE OF BUSINESS (Years)

ANALYSIS OF VARIANCE

VARIABLE	CODE	VALUE LABEL	SUM	MEAN	STD.DEV.	SUM OF SQUARES	N
CITY	2.	HALIFAX	510.0000	26.8421	16.0667	4646.5263	(19)
CITY	4.	ST. JOHN	527.0000	29.2778	16.4989	4627.6111	(18)
CITY	5.	QUEBEC CITY	484.0000	25.4737	17.6489	5606.7368	(19)
CITY	7.	MONTREAL	874.0000	19.4222	13.6023	8140.9778	(45)
CITY	10.	TORONTO	1042.0000	20.0385	14.4642	10669.9231	(52)
CITY	11.	KITCHENER	618.0000	30.9000	18.8816	6773.8000	(20)
CITY	13.	WINNIPEG	768.0000	25.6000	13.0400	4931.2000	(30)
CITY	14.	SASKATOON	475.0000	23.7500	14.2492	3857.7500	(20)
CITY	15.	CALGARY	341.0000	13.1154	10.4166	2712.6538	(26)
CITY	16.	VANCOUVER	606.0000	17.8235	14.7144	7144.9412	(34)
		WITHIN GROUPS TOTAL	6245.0000	22.0671	14.7149	49112.1201	(283)

ANALYSIS OF VARIANCE

SOURCE	SUM OF SQUARES	D.F.	MEAN SQUARE	F	SIG
BETWEEN GROUPS	6805.604	9	756.178	3.492	0.0004
WITHIN GROUPS	59112.120	273	216.258		

ETA = 0.3213 ETA SQUARED = 0.1032

Exhibit 21

X_1 INDUSTRY (Dummy) by X_{10} LOCATION (Dummy)

X10

COUNT / ROW PCT / COL PCT / TOT PCT

X1		SECONDARY 0	PRIMARY 1	ROW TOTAL
OTHER	0	107 48.0 85.6 37.3	116 52.0 71.6 40.4	223 77.7
MANUFACTURING	1	18 28.1 14.4 6.3	46 71.9 28.4 16.0	64 22.3
COLUMN TOTAL		125 43.6	162 56.4	287 100.0

CORRECTED CHI SQUARE = 7.18850 WITH 1 DEGREE OF FREEDOM, SIGNIFICANCE = 0.0073
RAW CHI SQUARE = 7.97575 WITH 1 DEGREE OF FREEDOM, SIGNIFICANCE = 0.0047

NUMBER OF MISSING OBSERVATIONS = 5

Exhibit 22

X_5 EXPORT (Dummy) by X_{10} LOCATION (Dummy)

X10

X5	COUNT / ROW PCT / COL PCT / TOT PCT	SECONDARY 0	PRIMARY 1	ROW TOTAL
NO	0	104 49.3 95.2 38.8	107 50.9 73.3 39.9	211 78.7
YES	1	18 31.6 14.8 6.7	39 68.4 26.7 14.6	57 21.3
	COLUMN TOTAL	122 45.5	146 54.5	268 100.0

CORRECTED CHI SQUARE = 4.98409 WITH 1 DEGREE OF FREEDOM, SIGNIFICANCE = 0.0256
RAW CHI SQUARE = 5.67576 WITH 1 DEGREE OF FREEDOM, SIGNIFICANCE = 0.0172

NUMBER OF MISSING OBSERVATIONS = 24

Exhibit 23

X_6 SCOPE (Dummy) by X_{10} LOCATION (Dummy)

X10

X6	COUNT / ROW PCT / COL PCT / TOT PCT	SECONDARY 0	PRIMARY 1	ROW TOTAL
ONLY LOCAL DISTR	0	56 45.9 43.8 19.2	66 54.1 40.5 22.7	122 41.9
PROV. TO NAT. DI	1	72 42.6 56.3 24.7	97 57.4 59.3 33.3	169 58.1
	COLUMN TOTAL	128 44.0	163 56.0	291 100.0

CORRECTED CHI SQUARE = 0.19326 WITH 1 DEGREE OF FREEDOM, SIGNIFICANCE = 0.6602
RAW CHI SQUARE = 0.31280 WITH 1 DEGREE OF FREEDOM, SIGNIFICANCE = 0.5760

NUMBER OF MISSING OBSERVATIONS = 1

B. SOME INTRODUCTORY REMARKS ON DEPENDENT VARIABLES

Before turning to the results of multivariate discriminant analyses, a few general observations are reported. Exhibit 24 divides the respondents into a group that did not usually get as much financing as they applied for, group 1, and a group that usually or always got as much or more than they applied for, group 0. The value 1 would then indicate that the respondent had run into some financing problem in the past, while the value 0 would imply no problems. The exhibit shows that there is no relationship between the presence of financing problems and proximity to one of the big four cities per se.

Exhibit 24

DID NOT ALWAYS GET AS MUCH AS APPLIED FOR by X_{10} LOCATION (Dummy)

YD1	X10 COUNT / ROW PCT / COL PCT / TOT PCT	SECONDARY 0	PRIMARY 1	ROW TOTAL
NO	0	112 45.7 92.6 40.7	133 54.3 86.4 48.4	245 89.1
YES	1	9 30.0 7.4 3.3	21 70.0 13.6 7.6	30 10.9
	COLUMN TOTAL	121 44.0	154 56.0	275 100.0

CORRECTED CHI SQUARE = 2.07878 WITH 1 DEGREE OF FREEDOM, SIGNIFICANCE = 0.1494
RAW CHI SQUARE = 2.67857 WITH 1 DEGREE OF FREEDOM, SIGNIFICANCE = 0.1017

NUMBER OF MISSING OBSERVATIONS = 17

In exhibit 25, the respondents are divided into a group 1 that rated finance as a 5,6 or 7 on the semantic differential scale of importance of problems facing the business and a group 0 that rated finance as 1 through 4. That is, group 1 respondents were those who considered finance to be more important than average and group 0 less than average. The exhibit shows that the presence of a full time financial manager, per se, has no statistically significant effect on the importance given finance as a problem facing the business. Later, however, it will be shown that when other variables are considered simultaneously, depth of financial is in fact the critical factor in obtaining satisfactory financing.

Exhibit 25

IMPORTANCE OF FINANCING VS. OTHER PROBLEMS by X_8 FINANCIAL MANAGEMENT DEPTH (Dummy)

X8

YG	COUNT / ROW PCT / COL PCT / TOT PCT	FULL-TIME MGR NO 0	YES 1	ROW TOTAL
0 FIN. LESS IMPORT	COUNT	112	40	152
	ROW PCT	73.7	26.3	52.6
	COL PCT	51.4	56.3	
	TOT PCT	38.8	13.8	
1 FIN. MORE IMPORT	COUNT	106	31	137
	ROW PCT	77.4	22.6	47.4
	COL PCT	48.6	43.7	
	TOT PCT	36.7	10.7	
COLUMN TOTAL		218	71	289
		75.4	21.6	100.0

CORRECTED CHI SQUARE = 0.34857 WITH 1 DEGREE OF FREEDOM, SIGNIFICANCE = 0.5549
RAW CHI SQUARE = 0.52886 WITH 1 DEGREE OF FREEDOM, SIGNIFICANCE = 0.4871

NUMBER OF MISSING OBSERVATIONS = 3

Exhibit 26 shows that there was no significant difference in the proportion of respondents who had been turned down for financing in the past three years near the big four as opposed to those not near the big four. Exhibits 27 to 30 show that the proportion of respondents who had turned down financing in the past three years near the big four as opposed to those not near the big four. These exhibits show that the proportion of respondents who turned down firm offers of short term debt, long term debt, lease financing and equity was independent of proximity to the big four as well. From these exhibits, we conclude that there is no effect of proximity to the large centres per se on the importance of financing problems, the rejection of financing offers by borrowers or the rejection of borrowers by lenders.

Exhibit 26

WAS THE RESPONDENT EVER TURNED DOWN?
by X_{10} LOCATION (Dummy)

YB3	X10: COUNT / ROW PCT / COL PCT / TOT PCT	SECONDARY 0	PRIMARY 1	ROW TOTAL
NO	0	18 34.6 14.2 6.2	34 65.4 21.0 11.8	52 18.0
YES	1	109 46.0 85.9 37.7	128 54.0 79.0 44.3	237 82.0
	COLUMN TOTAL	127 43.9	162 56.1	289 100.0

CORRECTED CHI SQUARE = 1.80237 WITH 1 DEGREE OF FREEDOM, SIGNIFICANCE = 0.1794
RAW CHI SQUARE = 2.24039 WITH 1 DEGREE OF FREEDOM, SIGNIFICANCE = 0.1344

NUMBER OF MISSING OBSERVATIONS = 3

Exhibit 27

REJECTED OFFERS OF FINANCING SHORT TERM by X_{10} LOCATION (Dummy)

YD2A	X10 COUNT / ROW PCT / COL PCT / TOT PCT	SECONDARY 0	PRIMARY 1	ROW TOTAL
NO	0	100 45.7 79.4 36.1	119 54.3 78.8 43.0	219 79.1
YES	1	26 44.8 20.6 9.4	32 55.2 21.2 11.6	58 20.9
	COLUMN TOTAL	126 45.5	151 54.5	277 100.0

CORRECTED CHI SQUARE = 0.00000 WITH 1 DEGREE OF FREEDOM, SIGNIFICANCE = 1.0000
RAW CHI SQUARE = 0.01288 WITH 1 DEGREE OF FREEDOM, SIGNIFICANCE = 0.9096

NUMBER OF MISSING OBSERVATIONS = 15

Exhibit 28

REJECTED OFFERS OF FINANCING LONG TERM by X_{10} LOCATION (Dummy)

YD2B	X10 COUNT / ROW PCT / COL PCT / TOT PCT	SECONDARY 0	PRIMARY 1	ROW TOTAL
NO	0	97 43.6 78.9 35.8	126 56.5 85.1 46.5	223 82.3
YES	1	26 54.2 21.1 9.6	22 45.8 14.9 8.1	48 17.7
	COLUMN TOTAL	123 45.4	148 51.6	271 100.0

CORRECTED CHI SQUARE = 1.40891 WITH 1 DEGREE OF FREEDOM, SIGNIFICANCE = 0.2352
RAW CHI SQUARE = 1.81380 WITH 1 DEGREE OF FREEDOM, SIGNIFICANCE = 0.1781

NUMBER OF MISSING OBSERVATIONS = 21

Exhibit 29

REJECTED OFFERS OF FINANCING LEASE by X_{10} LOCATION (Dummy)

X10

YD2C	COUNT / ROW PCT / COL PCT / TOT PCT	SECONDARY 0	PRIMARY 1	ROW TOTAL
NO	0	94 42.5 81.0 36.2	127 57.5 88.2 48.8	221 85.0
YES	1	22 36.4 19.0 8.5	17 43.6 11.8 6.5	39 15.0
	COLUMN TOTAL	116 44.6	144 55.4	260 100.0

CORRECTED CHI SQUARE = 2.05216 WITH 1 DEGREE OF FREEDOM, SIGNIFICANCE = 0.1520
RAW CHI SQUARE = 2.58320 WITH 1 DEGREE OF FREEDOM, SIGNIFICANCE = 0.1080

NUMBER OF MISSING OBSERVATIONS = 32

Exhibit 30

REJECTED OFFERS OF FINANCING EQUITY by X_{10} LOCATION (Dummy)

X10

YD2D	COUNT / ROW PCT / COL PCT / TOT PCT	SECONDARY 0	PRIMARY 1	ROW TOTAL
NO	0	106 47.3 90.6 41.1	118 52.7 83.7 45.7	224 86.8
YES	1	11 32.4 9.4 4.3	23 67.6 16.3 8.9	34 13.2
	COLUMN TOTAL	117 45.3	141 54.7	258 100.0

CORRECTED CHI SQUARE = 2.09889 WITH 1 DEGREE OF FREEDOM, SIGNIFICANCE = 0.1474
RAW CHI SQUARE = 2.66869 WITH 1 DEGREE OF FREEDOM, SIGNIFICANCE = 0.1023

NUMBER OF MISSING OBSERVATIONS = 34

Exhibit 31 is a cross-tabulation of the degree of satisfaction reported by respondents concerning how well they had been served by financial institutions by the four most frequently mentioned types of institutions, with a fifth category, "other" to capture less frequently mentioned sources of supply such as credit unions, investment dealers and life insurance companies. Since the chi-square statistics is not significant at the .05 level, we must report that there was no significant difference overall in the degree of reported satisfaction with Banks, Trust companies, financial corporations, FBDB and others, if significance is taken to mean "statistical significance at the 95% level of confidence".

Exhibit 31

SATISFACTION WITH SERVICE PROVIDED BY FINANCIAL INSTITUTIONS

	Rating		
	Very Poor to Adequate	**Well to Very Well**	**Total**
Chartered Bank	141	149	290
Trust Company	7	13	20
Financial Corp.	7	22	29
FBDB	7	11	18
Other	14	26	40
Total	176	221	397

Chi Square: 9.377
Critical values for chi-square with 4 degrees of freedom:

Level	X^2
.10	7.779
.05	9.488

The results of this section's tests are all negative, in the sense that we are unable to identify important differences in financing problems or satisfaction with financial institutions using simple univariate techniques. This in itself indicates that financing problems cannot be easily identified in terms of single explanatory variables and justifies the use of multivariate techniques that follow.

C. INTRODUCTION TO THE DISCRIMINANT ANALYSES

Altogether, nearly 100 discriminant analyses were run, directed at specific financing questions. The output from these analyses is voluminous, averaging 3 to 5 pages per run. Exhibit 32 summarizes the results of all of these runs on four pages, and provides an index to the original output, copies of which are included as a separate appendix X, available on request. In exhibit 32 we report the significance level of Rao's V statistic, a general measure of how significant the discriminant function is, overall, in explaining the difference between groups in the dependent variable. Though the eleven explanatory variables do not tell the whole story of what kinds of firms are to be found in which of the groups, they tell an important part of the story, and they are the variables that are probably most readily observable for public policy purposes or for market segmentation studies by NBFIs.

DEMAND SIDE SURVEY
DISCRIMINANT ANALYSIS - SUMMARY
AND INDEX TO APPENDIX - EXHIBITS

COEFFICIENTS - STANDARDIZED AND SIGNS ADJUSTED
TO CONFORM WITH 1 = YES IN DEPENDENT VARIABLE

											← Second Level		→
	APPENDIX EXHIBIT	SIGNIFICANCE OF RAO'S V STATISTIC	X_1 INDUSTRY	X_2 SALES	X_3 ASSETS	X_4 AGE	X_6 SCOPE	X_7 GROWTH	X_8 FIN. MGR.	X_{10} LOCATION	X_5 EXPORT	X_9 TRAINING	A_6 EMPLOYMENT
A. Importance of sources of advice for financial policy													
YA1 - Financial manager	1	.0001			.23		-.25		.47	-.41	-.25	.58	
YA2 - Other internal advice	2	.07		.27						.66		-.57	.63
YA3 - Banker	3	θ		.44	-.40			-.34	-.31	-.73		.25	
YA4 - Public accountant	4	.002				.45		.69		-.76			
YA5 - Other external advice	5	.07	-.35								-.45	.82	
YA6 - Major shareholder not active in business	6	.10	.42	.37					.22	-.49		.46	
B. Mismatching maturities (short loans for long purposes)													
YB1 - Who mismatches (Yes = 1)	7	.15	.52				.47					.49	
YB2 - Desirable (1) or not (0)	8	.07					-.63	.86					
YB3 - Always or usually forced (1) versus other (0)	9	.06		-.54		-.36	.36	-.52			.68	-.36	
C1. Shopping for capital: Who would approach what sources?													
a) SHORT B3A1 - Own shareholders	72	.04			-.82		.75						
3 - Friends, relatives	73	.05		-.35		-.47			-.25				-.44
5 - Caisse populaire or Credit union	74	.007				-.35		-.31	-.54	.45	-.47		
7 - Chartered bank	75	.02				.15		-.91			.56		
9 - Financial corporation	76	.06		.76		-.79			-.30		-.43		
11 - Trust company	77	.07		.86					-.85				
b) LONG B3B1 - Own shareholders	78	.17 blank→											
3 - Friends, relatives	79	.07				-.57		-.41	-.71				
5 - Caisse populaire or Credit union	80	.04				-.75			-.62				
7 - Chartered bank	81	.13				.84			.52				
9 - Financial corporation	82	.002	.54	.34	.42	-.34				-.31		.40	
11 - Trust/Mortgage company	83	.03			.71		-.43			-.61			
13 - Life insurance co. / Pension fund	84	blank→											
15 - Investment dealer	85	.05				-1.0							
17 - FBDB	86	.04	.46						-.73				-.41
c) EQUITY B3C1 - Own shareholders	87	.07			.48				.29			.58	
3 - Investment dealer	88	.007				-.60	.46		-.36				-.60
5 - Venture capitalist	89	.009					.62	.60				.39	-.34
7 - FBDB	90	.15									-1.0		
C2. Shopping for capital - stated degree of satisfaction													
YC2A - Served very well (1) or not(0) by source	10	.002						-.38	.46	-.55		-.49	.41
YC2B - Served (second-mentioned source)		.05				-.53			.91			-.57	
YC2C - Served (third-mentioned source) - small sample		θ	.17	-.84			-.53		.76	-.57		.50	
M. General complaints re sources of finance	35	.002							-.45	.75			-.34
K. Government intervention: More (1) or less (θ)?	34	.03	.47		-.71				-.40				
D. Past financing experience													
YD1 - Usually got less than applied for	13	.0005				-.39	.56	-.42		.45	-.53	.52	
YD2A - Respondent rejected offer - short	14	θ	.36	.56		.11	.33		-.29		.21		
B - - long debt	15	.01			.48		.57		-.32		-.57		.46
C - - lease	16	θ	.27	.77	.23	.24							
D - - equity	17	.01		.39			.30	.54	-.54	.43			
YD3 - Source turned down respondent	18	.11	.42							-.68		-.55	.45
U. Factors that would be important for assessing offers													
a) SHORT YU1A - Interest rate	49	.002	.41			.33			-.69	.55	.32		
B - Not enough funds offered	50	.08		.71	-.41		.64		-.52				
C - Too much collateral required	51	.12	-.43	.83	-.68			.50					
D - Repayment schedule too rapid	52	.01		.82	-.73	.44							
E - Covenants too restrictive	53	.001		.30		.51	.46						
F - Personal guarantee required	54	.0005		1.0									.36
b) LONG YU2A - Interest rate	55	.007	.48			.45			-.63	-.28	.32		.32
B - Not enough funds offered	56	.2		.73	-.92								.64
C - Too much collateral required	57	.05		.62	-.73	.59				.41			
D - Repayment schedule too rapid	58	.005	.40	.62	-.51	.59							
E - Covenants too restrictive	59	.001				.75	.25		.38		.28		
F - Personal guarantee required	60	.002	-.24	.82	.34			.35				.26	
c) LEASE YU3A - Rental payment too high	61	.03	.30		-.77	.44	.44					.49	
B - Lease not long (time) enough	62	.08					.62		.81		-.45		
C - Covenants too restrictive	63	.14		.60	-.92		.37						.69
D - Cancellation terms too severe	64	.04		.20			.43						.73
E - Lessor participation clause unsuitable	65	.15											
F - Personal guarantee required	66	.04	.33	.48				.29		-.48			.46
G - Implicit interest rate too high	67	.008		.62								.34	
d) EQUITY YU4A - Price per share too low	68	.06	1.0										
B - Amount of financing available	69	.16											
C - Control of operations via voting shares	70	.005	.42	.46	.69			.29	-.35				
D - Suitability of buy-back agreement	71	.05	.75	.61			-.55						
N. Importance of problems facing business (1 = more important)													
YN1 - Marketing	36	.014	-.27	.40		.41	.65			.37	-.40	.33	
2 - Production	37	.004	.74	.21		-.51		-.44	.20				.28
3 - Inflation	38	.007				.46		-.41	-.53	-.26			.43
4 - Government red tape	39	.10	-.59	-.36		.48	.68					-.41	
5 - Personnel	40	.0001	.48	.26	.15	-.42	-.22	.56			-.48		.39
YG - Finance	41	.10					.56					.72	
YN7 - Public Services (e.g. postal)	42	.0012				.56	.66			.61			
8 - Labour relations	43	.002		.31	.14								.74
9 - Corporate tax	44	.057		.61						-.53	-.62		
10 - Personal tax	45	.040		.34	.40	-.53	-.66			-.52			
11 - Cost controls	46	.0002		.72				-.27	.48				
12 - Professional services	47	.08	-.68		.70			-.45	-.44				
F. Importance of objectives (1 = more important)													
YF1 - Maintain control and independence	26	.01	.64			.68	-.44			.47			
2 - Growth in sales	27	.17											
3 - Increase operating efficiency	28	.0003	.60	.37						.57	.39		.38
4 - Increase profits	29	.002		.29					-.69	.34		.72	.56
5 - Lifestyle - sacrifice potential growth	30	.11			-.36	.53					-.46	-.53	
6 - Sell out	31	.006				.82			-.65				
7 - Refinance	32	.08	.51			-.33	.61	.52			.45	.42	
8 - Be a good corporate citizen, sacrifice other	33	.15											
E. Future plans and policies													
YE1 - Has a budget (1) or not(0)	19	θ	.56		.28	-.23	.19	.24	.30	-.26		.23	
YE2 - Budget covers more than 1 year (1) or not (0)	20	.07											
YE3A - Foresee short-term financing problem } BUDGET	21	.008					.53			-.40	-.54	.69	-.42
B - Foresee long-term financing problem	22	.01		.69			.44	.46	-.55		-.69	.56	-.33
C - Foresee equity financing problem	23	.076		-.65		.75	-.48					.62	
D - Foresee any problem financing in future	24	.07										.97	-.51
E - Foresee problem: no budget	25	.021		-.30		-.43	.50	-.77			.39		

In exhibit 32, the signs were adjusted so that a positive sign on X_2 (sales) would have the interpretation that firms with higher values for X_2 would tend to belong to group 1 instead of group 0 for the dependent variable.

Generally, the results in exhibit 32 are not discussed in detail here unless Rao's V is significant at the .05 level. Occasionally, results are reported at lower significance levels if the research question is of special importance to our sponsors, along with a caveat that there is more than 5% chance that such explanatory variables might **seem** to be significant in a sample of this size, even when they were not.

A technical note on the stepwise procedure (may be skipped without loss of continuity):

One way to run discriminant analyses is to insist that signs and coefficients be computed for <u>all</u> of the explanatory variables, whether they contribute significantly to the discrimination or not. Another way, which we find preferable in a study such as this, is to introduce the variables stepwise into the analysis. As an informal description of how this affects the analysis, we can say that generally, the program looks for the variable that makes the most significant contribution to the statistical difference between the groups (as measured by Rao's V statistic). Then, given that this variable has contributed as much as it can to the discrimination, the programme searches for the next most important variable, and so on. This can sometimes result in more powerful discrimination than if all of the variables had been included and it certainly highlights the key variables much more efficiently.

Another problem is that if two or more of the independent explanatory variables are highly correlated with each other, the coefficients will be unstable from one sample to another. We have three measures of size of the business: sales, assets and number of employees, and two measures of the depth of financial management: full time or not and formal designation or not. In addition, the export and scope variables are probably measuring the same thing, to some extent. Rather than let these variables compete among themselves, we chose to enter them at different levels in the analysis. We left sales and assets at the higher level, 3, but relegated number of employees to the lower level 1 in the analysis. We felt that there would be categories of businesses for which sales or assets were better measures of size, so that they should be allowed to compete with each other as potentially significant discriminators, but that the number of employees was very likely highly correlated with one or the other. In summary, we chose to enter the variables stepwise at the following levels.

Level 3: to be examined first

- X_1 industry, manufacturer or not
- X_2 sales
- X_3 assets
- X_4 age of business
- X_6 scope of distribution of product or service
- X_7 growth rate
- X_8 full time financial manager or not
- X_{10} location, near big four or not

Level 1: to be examined after the significant variables in level 3 have entered the analysis:

- A_6 number of full time employees
- X_5 export or not
- X_9 does financial manager have formal credentials (CA, RIA, etc.), yes or no.

Generally, this procedure was successful in isolating key variables of interest and providing logical interpretations of the discriminant functions.

D. THE INSTITUTIONS

The research question asked in this section is, "what are the characteristics of firms who say that they would approach source "x" if they were shopping for capital, as opposed to the firms that do not say they would approach that source?" The results of our analysis are reported in section C1 of exhibit 32.

(a) Short term debt:

1. Own shareholders: Firms that say they would approach their own shareholders for short term finance tend to be small in terms of fixed assets, but more than local in scope. It is to be noted here that the coefficients of the explanatory variables have all been normalized (divided by the explanatory variables' standard deviations). If this were not done, the coefficients on large variables, such as sales, would be tiny and the coefficients on the smaller variables, such as age of business, would be comparatively huge. When the coefficients are normalized, the size of the coefficient (ignoring its sign) is roughly proportional to its relative importance as a means of discriminating between the two groups of dependent variables. In this particular run, the sign on assets was -0.82 and that on scope .75. Looking at the appendix exhibit (available on request), we see that average assets of respondents who would approach shareholders was about $625,000 compared with nearly $900,000 for those who would not approach their own shareholders; 64% of those who would approach their shareholders were of more than local scope, whereas 54% of those who

would not approach them were of more than local scope. The difference in assets is significant only at the .09 level by itself and the difference in scope .13: that is, neither is statistically significant by itself in explaining the grouping, but together they are significant at the .04 level.

The conclusion from this particular run, then, is that firms that would resort to borrowing short term from their own shareholders tend to be those with lower asset bases who need temporary financing to support more than local distribution of their product or service.

2. Friends and relatives: Firms who would approach friends and relatives tended to be those that were small both in terms of sales and number of employees, younger than average and lacking a full time financial manager. Two of these variables were significantly different at the .05 level, by themselves between the two groups:

	Group		
	1 Would approach	0 Would not	Significance
Mean sales	$935,000	$1,900,000	.04
Mean no. of employees	12	30	.02

The other two variables that entered the discriminant analysis were not significant alone, but were of some assistance in tandem with the first two variables:

	Group		
	1 Would approach	0 Would not	Significance
Mean age of business	18 years	24 years	.06
Proportion respondents with financial manager	13%	26%	.11

From this point on, variables whose means differ significantly between groups by themselves will be marked by an asterisk in tables such as the one above.

3. Caisse populaire or credit union: Firms that would approach a credit union for short term financing tend to lack a financial manager, to be near one of the big four centres, to be younger than average and to be growing less quickly than average. The most critical variable here appears to be the absence of a full time financial manager; Only 4% of the caisse users had one, compared with 27% of the non-users. This difference is significant at the .01 level in our sample firms.

4. Chartered bank: Since nearly everyone said he or she would approach a bank for short term financing, we have little confidence in the results of this analysis: only 8 respondents said they would not approach a bank and of these, some may simply have failed to answer the question.

5. Financial corporations and trust companies: Neither of our runs is significant at the .05 level, so we do not feel confident in generalizing here.

(b) Shopping for long term debt or lease financing.

Our runs failed to turn up any significant results for own shareholders, friends and relatives or chartered banks here.

1. Caisses: Again, young firms without financial managers turned out to be more inclined to approach caisses. The same results were reported previously for approaches to caisses for short term financing.

2. Financial corporations: Firms that would approach these institutions for long term financing were young manufacturers, relatively large in terms of both sales and assets, located away from the big four centres, with some formal training in financial management. Some summary statistics for the two groups are as follows:

	1 **Would approach**	0 **Would not**
Mean sales*	$2,400,000	$1,500,000
Mean assets*	$1,100,000	$ 640,000
Mean no. of employees	39	23
Proportion with full time financial manager*	33%	21%
Proportion with formal financial training*	33%	17%
Proportion manufacturers*	35%	19%

3. Trust and mortgage companies: Not surprisingly, the approachers here had higher than average asset levels. These institutions are generally in the business of lending secured by specific assets. In addition, there was a tendency for approachers to be away from the big four centres and to be not more than local in the scope of their product or service distribution.

	1 Would approach	**0 Would not**
Mean Assets*	$1,000,000	$690,000
Proportion near big four*	42%	56%

4. FBDB: Here users tend to be small manufacturers without a financial manager. The only variable that by itself is significantly different between the users and non-users is the proportion of firms with a full time financial manager: 15% of users vs. 29% of non users.

(c) Shopping for equity funds

We were unable to identify many important trends in this market segment. The only logical and consistent result that we feel confident to report upon is that small firms (few employees), growing fast, with already more than local scope and with formal training in financial management say that they would approach venture capitalists more often than other types of firms. These firms are evidently willing to trade off some possible loss of share ownership for expansion and growth.

E. SHOPPING FOR CAPITAL - DEGREE OF SATISFACTION WITH INSTITUTIONS

Section C2 of exhibit 32 concerns the satisfaction scores given to the financial institutions with which respondents have dealt. Some of the information in this question was summarized earlier in this section of the chapter, in exhibit 31, which demonstrated no significant difference in the degree of satisfaction reported for various types of institutions (including FBDB) in general. In the discriminant analysis, runs were made for the first three mentions of institution names. The striking common thread here is that firms who tended to score their degree of satisfaction with the institutions as high or very high tended to have full time financial managers, whereas those who said that they were served less than very well tended not to have full time financial managers. This is not surprising, though it is an important finding. Managing a firm's finances is a complex affair and without a full time financial manager, it is easy to miss opportunities to improve upon what is being done in terms of financial strategy. From this we conclude that firms that report dissatisfaction with financial institutions may really be lamenting the fact that they have not devoted enough time to the firm's finances themselves.

General complaints regarding sources of finance:

Respondents were asked to supplement their ratings of satisfaction with qualitative comments regarding why they thought they had been well served or not well served. Firms that registered complaints regarding service in general were assigned to group 1 and those who did not or who praised financial institutions with which they had dealt were assigned to group 0, making use of the postcoding. The highly significant results of the discriminant analysis are summarized in section M of exhibit 32. Complainers were generally small firms without a financial manager near one of the big four cities:

	1 complainers	0 non-complainers
Mean no. of employees*	17	34
Proportion with full time financial manager*	16%	32%
Proportion near big four*	68%	43%

This is consistent with the result reported immediately above. It seems that the key to satisfaction is to hire a full time financial manager. Quite probably, the smaller of the small businesses in the sample view the cost of hiring one as greater than the extra satisfaction they might receive in their financial dealings generally, however.

Attitude toward government intervention:

It seems logical to expect that the firms who are dissatisfied with their financial experiences will tend to say that the government ought to help them with some sort of a subsidy. Part K. of exhibit 32 tends to confirm this expectation. Firms whose managers said that the government ought to intervene more in the small business financing sector were generally small manufacturers without a full time financial manager. Again the presence of a full time financial manager seems to be a key explanatory variable. Some key statistics are as follows:

	1 gov't should intervene more	0 should not
Mean sales*	$1,500,000	$2,000,000
Proportion of manufacturers	25%	18%
Proportion with full time financial manager*	19%	29%

CONCLUSIONS

From the discriminant analyses in this part E of section V, we conclude that problems experienced by small businesses with regard to financing derive not so much from some immutable characteristics of the businesses themselves, as from the absence of a qualified person who is willing to devote the time required to manage the firm's finances properly. This would imply that government subsidies, if they are given at all, ought to be directed not at improving the explicit cost or terms of financing for some subset of small businesses, but at the sophistication of financial management in the firms experiencing difficulty. Such assistance might consist of training programs or the provision of financial consultants who would visit the businesses intermittently to ensure that the firms were following rational financial management practices. Possibly, there is an argument for expanding the traditional role of public accountants in this regard, since they are already associated with the businesses. We hesitate to recommend this, though, because we have no way of knowing whether in general the accountants servicing small businesses are competent in financial matters. Thornton (1981), for instance, found that in Ontario small clients tended to be served by small CA firms in which the degree of education other than conventional accounting training was much lower on average than that in larger CA firms serving larger business clients.

F. PAST FINANCING EXPERIENCES

Section D of exhibit 32 analyzes who has rejected various offers of finance and who has been turned down by sources of finance. The first run assigns to group 1 those firms who usually got less financing than they applied for. These tended to be young, non-exporting firms of more than just local scope, growing less quickly than average, near one of the big four cities and with formal training in financial management even though there was no marked trend for the financial manager to be full time.

	1 trouble	0 no trouble
Mean age	17 years	23 years
Proportion exporting	10%	21%
Proportion with more than local scope	76%	57%

One scenario that is consistent with these findings is that these firms perhaps started expanding their scope too rapidly without the business experience or the asset base to obtain the financing required to maintain their growth rates.

A related question in section D of exhibit 32 is "who was turned down by sources of financing in the past?" Unfortunately, this run produced no significant results, and the signs of the coefficients bore no relation to the signs of those in the run reported in the paragraph immediately preceding.

Shopping by the respondent:

The four runs labelled YD2A to YD2D analyze what kinds of firms have turned down offers of financing by the various sources of supply. To some extent, these firms might logically be expected to be those that did not experience trouble and that were not turned down by financial institutions. It will be recalled from section III of this chapter that very few of the respondents who rejected firm offers of financing did so because the best offer was not tolerable. Thus, rejection by the respondent is more a sign of discrimination or "shopping around" in the market for funds than a sign of frustration. The common thread in these analyses is that the shoppers tended to be larger firms, where size is measured in terms of assets, sales or number of employees. Evidently larger firms have more alternatives open to them, so that they can afford the luxury of turning down firm offers of financing more often than small firms.

G. IMPORTANT FACTORS IN ASSESSING AN OFFER OF FINANCE

These factors are analysed in section U of exhibit 32 under the headings short term debt, long term debt, leases and equity finance. To facilitate the identification of common findings, some of the factors are grouped in exhibit 33.

1. Interest: For both short and long term loans, respondents who thought that the interest rate would be especially important as a factor in deciding whether to turn down an offer of financing tended to be older manufacturers without full time financial managers. Possibly, competent financial managers realize that there is little that can be done about the

prevailing rates of interest. It should be noted that at the time the survey was carried out interest rates in Canada were approaching an all time high, so it is especially likely that respondents without expertise in finance would say that interest was important relative to those who knew that there was little that could be done about it. Some summary statistics on the two groups are as follows:

	1 Interest more important	**0 Interest less important**
Proportion with full time financial manager		
Short term*	19%	34%
Long term	20%	30%
Proportion of manufacturers		
Short term	27%	16%
Long term*	30%	16%
Mean age		
Short term*	24 years	20 years
Long term*	24 years	19 years

Exhibit 33

SUMMARY OF DISCRIMINANT ANALYSIS FOR THREE FACTORS

	x1	x2	x3	x4	x6	x7	x8	x10	x5	x9	A6
Interest Rate											
Short term	.41			.33			-.69	.55	.32		
Long term	.48			.45			-.63	-.28	.32		.32
Lease(implicit)		.62								.34	
Amortization											
Short term		.82	-.73	.44							
Long term	.40	.62	-.51	.59							
Lease	.30		-.77	.44	.44					.49	
Personal Guar.											
Short term		1.00									
Long term	-.24	.82	.34			.35				.26	
Lease	.33	.48				.29		-.48			.46

2. Rapidity of the pay-back schedule: Firms that rated this factor higher than average were older firms with higher sales than average, but lower assets than average (see exhibit 33). Possibly, this segment of firms lacks the asset base to support senior secured debt, so that lenders look primarily to the firm's cash flow in offering finance. Virtually none of these variables by itself exhibited a significant difference between the two groups, however, so no summary statistics will be given.

3. Personal guarantee: Firms that said that the requirement of personal guarantee would be an important factor in deciding to reject an offer of finance tended to be large in terms of sales, assets or number of employees. Of course, these are the very firms that can avoid giving such guarantees when they borrow, so this result is precisely what would be expected.

4. The equity market: None of the runs in section U (d) of exhibit 32 produced interesting results. Perhaps the one interesting generalization that can be made here is that the equity market in the small business segment is not well enough developed at present for the respondents to be able to answer the question consistently on the basis of what they know.

H. IMPORTANCE OF SOURCES OF ADVICE FOR FINANCIAL POLICY MAKING

1. Financial manager: Not surprisingly, firms that rated the financial manager as an important source of advice were those who had one or who had some expertise in financial management. This result is trivial indeed, since it results from the way in which we have defined the explanatory variables in the first place. Nonetheless, it is comforting to note that the data are being analyzed in a way that produces consistent and logical results where expected. Also, it may be said that since firms who have full time financial managers value their advice quite highly, firms without them should ponder carefully the possible benefits of hiring one.

2. Banker and public accountant: The banker was viewed as an important source of advice by firms without a full time financial manager, located away from the big four cities. Public accountants were rated important by older firms away from the big four cities, growing more rapidly than average.

I. MISMATCHING MATURITIES

The question of who mismatches maturities and, of those, who does so involuntarily or reluctantly, was raised in section IV. Several attempts were made to characterize such firms (see section B of exhibit 32). We must report that we cannot find any significant relationships between the explanatory variables that we have defined and the phenomenon of mismatching. Either mismatching is the result of other, largely unobservable explanatory variables or it is a purely random process.

J. ON THE RELATIVE IMPORTANCE OF PROBLEMS FACING THE BUSINESS

Section N of exhibit 32 attempts to describe the characteristics of respondents who gave to various problems facing their businesses more than a median rating score. Nearly all of the runs produced statistically significant Rao's V statistics, with the notable exception of finance itself, the primary concern of the study. (The other insignificant run concerned the importance of government red tape). It will be recalled, however, that on the average finance was rated significantly lower in importance than marketing, production, personnel and cost control, though significantly higher than labour relations and professional services. This in itself is important. Quite possibly, financing problems are derived problems, resulting from problems in the other functional areas of a business. Since combinations of these other problems may be distributed more or less randomly across the sample of firms, no logical pattern may be identifiable for finance **per se**. This is our interpretation of our results.

The significant runs are reported below in turn.

1. Marketing: Marketing was considered relatively more important by larger, older non-manufacturers of more than local scope. Some 65% of the respondents who thought marketing was especially important were of more than local scope. In comparison, only 49% of respondents who thought that marketing was relatively less important were of more than local scope. Evidently, the marketing function becomes substantially more complex as a firm's distribution area becomes larger.

2. Production: It is perhaps trivial to point out that by far the most important characteristic of firms that scored production as more important than average is that they were in the manufacturing sector. It will be recalled that in section IV, production ranked lower than marketing, inflation, personnel and cost controls on the average. The results of the discriminant analysis confirm what was intuitively obvious at that point: production, too, would have ranked with the other four problems as "most important" if all of the firms had been producers. If this is taken into account in examining figure 1, section IV, it then becomes apparent that the top five ranked problems are beyond a shadow of a doubt considered by the respondents to be more important than finance on average.

The proportion of manufacturers in the group of firms that scored production higher than average was 33% compared with only 15% in the group that scored production as less important than average. This difference in proportions is significant on its own at the .003 level. Other variables that contributed to firms' giving production higher than average importance scores, but which were not significant by themselves, were size (sales and number of employees positively contributing to higher scores), age (younger) and growth (negative).

3. Inflation: Inflation was considered relatively important by old, slowly growing firms without a financial manager, with more employees than average. It would seem that such firms are unable to keep up with rising demands of the wage bill because they are at a late stage in their life cycle: profits are not keeping pace with wage inflation. Some key statistics from the related appendix exhibit are as follows:

	1 Inflation more important	**0 Inflation less important**
Mean age*	25 years	20 years
Mean growth rate*	12.4%	16.4%
Mean no. of employees	31	23
Proportion with full time financial manager	21%	29%

4. Personnel: Exhibit 32 shows that personnel problems were relatively more important for large manufacturers with more employees, growing faster than average, but younger than average. It seems logical that on average a firm in this position could face some thorny personnel problems, especially in regions where skilled help was scarce. Nonetheless, there was no significant effect of location on the importance of the personnel factor, either as a stand-alone variable or in concert with other explanatory variables.

Some summary statistics for the two groups of firms are as follows:

	1 Personnel more important	**0 Personnel less important**
Mean number of employees*	33	19
Proportion who are manufacturers*	27%	16%
Mean growth rate per annum in sales*	16%	10%

5. Reliability of essential public services (e.g. postal service): The most important discriminating variable here was that the small businesses that rated this problem as relatively more important tended to be of more than local scope. Such firms no doubt make more use of communications services in order to co-ordinate their activities and deal with their customers. In addition, the group that rated this problem more highly contained somewhat older firms near the big four cities.

6. Labour relations: By far the most important discriminating variable here was number of employees, significant at the .0003 level by itself. In concert with this variable, sales and assets helped to discriminate between the groups:

	1 Labour relations more important	0 Labour relations less important
Mean number of employees*	38	18
Mean assets*	$1,000,000	$600,000
Mean sales*	$2,000,000	$1,400,000

7. Corporate and personal taxes: We were unable to discriminate between groups that thought corporate tax was relatively more and less important, though there was a tendency for firms in the "more important" category to be larger in terms of sales. The analysis for personal taxes is also difficult to interpret: though none of the explanatory variables is significant by itself, the discriminant function is significant at the .04 level. Firms that rated personal taxes as a relatively more important problem facing their business tended to be larger and younger than average, of local scope, and away from the big four cities.

8. Cost controls: Firms that rated cost controls relatively highly were large firms with full-time financial managers.

	1 More important	0 Less important
Mean sales*	$2,300,000	$1,100,000
Proportion with full time financial manager*	32%	16%
Mean number of employees*	35	19

K. ON THE IMPORTANCE OF OBJECTIVES FOR THE BUSINESS

Only 3 of our 8 analyses in section F of exhibit 32 produced significant results. The unsuccessful runs concerned the importance of the following objectives for the business:

- growth in sales
- increase profits
- have stable income and lifestyle, perhaps with some sacrifice of potential growth or profits
- refinance
- be a good corporate citizen, possibly at some sacrifice of other objectives

We could identify no consistent pattern of attributes of any significance to describe the firms whose managers held the foregoing objectives in higher and lower importance.

Our more successful runs are discussed in turn below.

1. Maintain control and independence: This objective was considered relatively more important by the managers of older manufacturers, of only local scope, located near the big four cities.

	1 More important	0 Less important
Proportion of manufacturers*	28%	15%
Mean age	24 years	20 years

We were interested to note that size did not enter the analysis in any form (sales, assets, number of employees). Apparently, this objective, when it is important, stays important to the principal owners or managers of the business regardless of its stage in the life cycle.

2. Increase operating efficiency: Large manufacturers near the big four cities considered this objective relatively more important:

	1 More important	0 Less important
Proportion of manufacturers*	33%	16%
Mean sales*	$2,100,000	$1,500,000
Mean number of employees	35	22
Proportion near big four*	61%	44%

3. Sell out: By far the most important discriminator here was age: managers or owners of older firms held this objective to be of higher importance. Quite probably, these people were thinking about establishing a retirement income and an estate to pass on to their heirs. In addition, such firms tended to lack a full time financial manager. Again, size did not enter the analysis.

	1 More important	0 Less important
Mean age of business*	29 years	22 years
Proportion with full time financial manager**	12%	27%

**Significant at .06 level

L. FINANCIAL PLANS AND POLICIES

The section of the questionnaire that elicited information concerning future plans and financial policies of the respondent business is analyzed in section E of exhibit 32. We wanted to know what sorts of small businesses engaged in formal financial planning and budgeting and how the perceptions of the respondents regarding future financing problems related to the degree of planning and budgeting.

1. What kind of firms had a formal budget? This was one of the most significant runs in exhibit 32. Firms that had a formal budget on hand, covering the next year or more, tended to be large manufacturers with a full time financial manager; younger, but growing somewhat more rapidly than average.

	1 Have budget	0 No budget
Proportion with full time financial manager*	38%	14%
Mean sales*	$2,545,000	$1,087,000
Mean assets*	$1,100,000	$ 500,000
Mean number of employees*	39	19
Proportion with formal designation in financial management*	31%	14%
Proportion of more than local scope*	69%	50%
Proportion who exported	25%	15%

Once again, some depth in financial management seems to be a prerequisite for successful growth and expansion of small business. (Or, alternatively, a necessity once the business becomes successful. It is not possible to say whether it is a cause of an effect on the basis of our analysis).

The ensuing analyses tried to determine what kind of budgeters foresaw potential future problems in obtaining the financing that would be needed to accomplish the firms objectives. Though a healthy proportion of the budgeters had a full time financial manager, many did not. It is interesting to note that the ones that did not were precisely the ones that foresaw some problem in obtaining long term debt on acceptable terms in the future. Budgeters who foresaw problems also tended to be smaller than the average budgeting firm in terms of number of employees.

2. The non-budgeters: The non-budgeters who foresaw future problems obtaining financing tended to be those whose growth rate was below average. Those who foresaw a problem had an average growth rate of 6%, as compared with 14% for non-budgeters who were more optimistic about future financing. An interesting question that arises, but which must remain rhetorical here, is whether this significant difference in growth rates is a cause or result of problems in obtaining financing.

V. HIGHLIGHTS AND CONCLUSIONS

A. The Overall Picture

1. The market for small business financing appears to be working reasonably well:

- only 1 in 4 of the respondents said that they had not always been able to obtain as much or more financing than they had applied for, on reasonable terms.
- Financial institutions, including both the banks and the NBFIs, had an enviable record of serving the financing needs of small businesses: fewer than 15% of respondents reported less than adequate service.
- Only a tiny fraction of the respondents said that they had rejected offers of financing because the best offer available to them was not tolerable. The rejections that did occur seemed to reflect discrimination in shopping on the part of the borrower rather than frustration of his or her objectives.
- It was uncommon for the small businesses in the sample to have been turned down by lenders. Fourteen percent of the respondents had been turned down once and 5% twice in the past three years, almost always by chartered banks. There was almost never any disagreement or dispute as to the reason for the rejection, and usually the rejected firm found financing elsewhere.

2. On the average, the small business people interviewed were most definitely **not** inclined to sacrifice growth, profitability, or efficiency for leisure time. From this it may be inferred that the lack of adequate financing, should it ever occur, would be an important constraint that could inhibit small business people from meeting their objectives and prevent them from making as large a contribution as possible to the country's economy.

3. Financing ranked well behind marketing, production, personnel, inflation and cost controls as a problem area for the average small business. Consequently, the evidence indicates that further government intervention in the market for small business financing must logically be viewed in relation to other means of assisting small businesses which the small business people themselves apparently hold in higher priority.

4. According to the respondents, lack of adequate financing would be manifest principally in curtailment of growth or expansion. Very few respondents were worried about insolvency or bankruptcy.

5. Whatever may be said by public policymakers or academic researchers concerning the potential dangers of mismatching, such a policy is **not** perceived as a serious problem by the small business managers themselves. Four out of ten respondents said that they used short term sources of funds to finance long term projects. Only 17 (5%) said they did so because there was no alternative, however. Moreover, two-thirds of the 40% who reported mismatching said that they found the policy desirable.

6. In the short term segment of the market for small business financing, shopping is minimal. Banks hold a major share of this market segment, owing in part to the many ancillary services that they can provide. Only shareholder loans are viewed as secondary sources of supply by a significant proportion of the respondents. However, from the very few respondents who said they would approach them, Credit Unions, Trust Companies and Financial Corporations received honourable mention.

7. There is little interest in outside equity sources of finance. This finding reflects mainly the very strong desire of small business people to remain independent. It may also be due to lack of information as to how equity financing might be structured to suit their needs, however.

8. Banks and shareholder loans are the most popular sources of long term loans, but by a much slimmer margin than in the short term end of the market. In particular, Trust Companies, Financial Corporations, and FBDB are viewed as viable potential sources of supply by the respondents.

9. NBFIs in general and lessors in particular are more popular than average among the more frequent shoppers. This suggests that advertising directed at less frequent shoppers may be desirable for NBFIs if they wish to penetrate the small business long term financing market.

10. There is some evidence of differences in shopping behaviour by location. Quebec City firms made relatively heavy use of caisses. St. John, Saskatoon and Quebec City firms were more willing to approach FBDB. Perhaps surprisingly, Trust Companies and Financial Corporations were somewhat less popular than average in Montreal and Toronto, where they flourish in other segments of lending markets.

11. Many small business managers may feel that government programmes are not worthwhile. The respondents were much more aware of federal programmes designed to assist small businesses than provincial ones. Nearly 90% of them thought that they were eligible for some sort of aid, and only 9% of those that had approached a federal agency had been refused assistance. Despite this, only 45% of the firms in the sample had ever made use of any assistance. One explanation of this curious result is that possibly the other 55% believe that the benefit of the subsidies to their firms is not worth the cost of applying for them. Such costs would include those caused by red tape, delays in obtaining assistance and the time of operating managers required in making application.
Approximately half of the respondents felt that the government should intervene more to assist small businesses. The other half believed that the government should intervene less, or were ambivalent.

12. The interest rate was unquestionably the most important concern of small business managers in deciding whether to turn down an offer of funds from lenders or lessors. This may reflect the fact that, at the time the survey was done, interest rates were at an alltime high in Canada.

13. In the equity market, control of the firm via voting shares was by far the most important factor considered.

14. Personal guarantees and collateral were items of contention. A common sentiment was that small businesses face considerable risk in relation to the collection of their accounts receivable, whereas the banks that lend money against these receivables are fully secured, often by personal guarantees backed by the personal assets of the borrower. Lenders apparently look almost exclusively to specific assets and personal guarantees as means of security in this sector of the financial market.

B. Analysis of Subsamples

The analysis of subsamples was based largely on multivariate discriminant functions. This type of analysis allows the researcher to control for many relevant variables simultaneously. Each is allowed to explain as much as it can of differences in subsamples in the presence of other important factors.

1. A striking common thread that became evident in the interpretation of the multivariate analysis is that the problems experienced by small businesses with respect to financing appear to result not so much from immutable characteristics of the businesses themselves, such as industry, location, or size as from the absence of a full time financial manager who is willing to plan the firm's financial strategy and able to devote the time that is necessary to maintain good relations with the sources of supply. This is not to say that these other variables were unimportant. They turned up quite often. But this variable - the presence or absence of a full time financial manager - seems to be most important.

2. Firms with full time financial managers:

- value their advice most highly for financial policymaking.
- are successful, young, fast-growing firms with formal budgets.
- tend to have formal cost control systems to promote operational efficiency.
- are less inclined to sell out.
- say inflation does not hit them as hard as firms without full time financial managers.
- are less inclined to complain about interest rates, about which little can be done in a competitive market for funds.
- tend to be more satisfied than average with the quality of service that they receive from financial institutions, and are much less likely to complain about the institutions.
- are more likely to approach financial corporations for financing.
- are less inclined to approach friends, relatives, shareholders, caisses or FBDB for financing. Except for the caisses, the other sources of supply would often be lenders of last resort.
- are less disposed to feel that governments should intervene in the financial marketplace to help firms like theirs, and more inclined to favour a "laissez faire' approach.

3. These findings point to the conclusion that subsidies given to small businesses (if they are given at all) ought to be directed not at lowering the explicit interest cost of financing, since this would do little or nothing to remedy the root causes of the dissatisfaction expressed by the small business managers. Rather, assistance should be directed at improving the quality of financial management of the enterprises.
   Perhaps several non-competing firms could pool their resources to hire a full time financial manager who would visit them regularly and ensure that the firms were following a rational financial policy. Consultants, such as CASE counsellors, will not fill the bill, since small business people approach them only when they perceive that they can help. The point here is that the small business people may not even know when they have a financing problem, and may be unaware of the financial benefits that could result from such assistance.

4. Small firms without full time financial managers are far more likely than average to approach shareholders, friends and relatives, or credit unions. Shareholder loans tend to be utilized by small firms that need temporary financing to support more than local distribution of their products or services.

5. For long term .debt and leases, large manufacturers with full fime financial managers tend to approach financial corporations. Trust companies are approached primarily by firms with large asset bases that can serve as collateral. FBDB is viewed a a viable source of financing only by small firms without full time financial managers.

6. The study was unable to identify any important considerations respecting client-investor matching in equity financing, since the firm's present shareholders were viewed as the only significant source of supply.

7. Shoppers, who had turned down more than an average number of genuine offers of finance, tended to be larger than average, as measured by sales, assets, or number of employees. It seems that larger firms, with proven earnings records and larger asset bases to use as collateral, have much more to bargain with than smaller, younger firms. Consequently, they can afford the luxury of turning down offers of finance without fear of ultimately being frustrated in the accomplishment of their objectives.

8. Different factors were cited as being more important by subsamples of the firms in deciding to turn down financing:

- Interest rates were particularly important to older manufacturers without full time financial managers. An experienced financial manager would realize that little could be done to lower interest rates, and perhaps be less inclined to complain about them as a consequence.
- Rapidity of the payback schedule was important to managers of firms that had higher sales but lower assets than average. It appears that such firms, which borrow primarily on the strength of their cash flow rather than their asset bases, are experiencing some difficulty in obtaining financing with terms to maturity that are long enough to suit them, and in consequence are more vulnerable to swings in interest rates than firms that have lots of collateral.
- Small firms' managers appear to be resigned to the fact that they must give personal guarantees in return for adequate financing. Large firms' managers will not tolerate such requests: presumably, the equity of the firm provides an adequate cushion for their lenders.

9. As was emphasized above, firms with full time financial managers value their advice very highly. Firms without them tend to rely on bankers and public accountants for such advice, with bankers

receiving a somewhat higher average rating. Though these external sources of advice no doubt do all they can to assist small businesses, they fall considerably short of providing adequate advice for a successful, growing business.

10. The research failed to identify any reliable description of businesses that were more likely than average to mismatch maturities. Mismatching appears to be a phenomenon that is not influenced to any significant degree by observable demographic variables in Canada's small business sector.

11. The importance of non-financial problems varies among categories of firms.

- Marketing is considered more important than average by non-manufacturing firms with wider distribution of their products or services.
- Inflation is considered to be more damaging than average by old, slow-growing firms without full time financial managers, and with more employees than average. It seems that such firms are unable to keep up with the wage bill under inflation, since they are in a late stage of their life cycles in which wages are outrunning profits.
- The reliability of public services, such as the postal system, is considered more important than average by managers of firms of more than local scope, which rely on many public services for coordination of their marketing efforts.
- Personnel problems are particularly acute for manufacturers with more employees than average.
- Labour relations laws are stumbling blocks primarily for large firms, which no doubt face unionization.
- Personal taxes are rated as especially important problems by the managers of young, larger than average, successful, fast-growing businesses.
- Cost controls are most important to large firms with full time financial managers. No doubt, the larger firms are experiencing the need for more formal management control systems to coordinate their operations and strategic plans.

12. The more successful firms have budgets. Four out of ten of the respondents had formal budgets covering the next year or more. Budgeters tended to be large manufacturers with a full time financial manager; younger, but growing more rapidly than average. The budgeters were quite confident that they would get the financing that they would require in the future, though they were somewhat less sanguine about obtaining long term financing than short term financing.
    The non-budgeters did not appear to be worried about future financing prospects either, but of course their needs would be somewhat more modest and arguably, they may not fully appreciate what their problems might be.

VI. THE QUESTIONNAIRE: POSTCODING AND DESCRIPTION OF VERBATIM RESPONSES

The first 120 questionnaires were edited and postcoded during the week of May 4, 1981. This section contains a summary and qualitative discussion of how the various questions were answered and describes how the verbatim responses were postcoded. The questions are discussed in the order in which they appear in the questionnaire. The reader may wish to keep a copy of the questionnaire (Appendix B-1) at hand to make the following analysis easier to follow. Answers that occurred more frequently are marked **.

P.(ii) Title of person interviewed "Other:"

Other answers included:

- partner
- owner manager; proprietaire
- bookkeeper who had a good understanding of business
- relative of the owner

P.2 Q.7 (b) Formal training of person who manages firm's finances:

- #202 reports financial manager took financial management course through the government.

P.3 Q.2 (b) Other reasons for mismatching maturities:

- convenience.
- this is a normal business practice.
- temporary measure to support asset expansion.
- FBDB too slow, too much red tape; had to do it.
- only source I approached.
- for security and bid deposits.

P.4 Other sources searched:

Short:
- Cash surrender value of life insurance
- leasing
- various provincial agencies of government: e.g., Ontario Development Corporation

Long:
- supplier or manufacturer

Equity:
- partners
- bank
- employees
- family

P.5 Financing Experience

"Other"answers to type of funding (any episode)

- trade credit
- demand notes

Other answers to type of supplier (any episode)

- insurance company
- manufacturer of equipment; supplier of inventory
- mortgage company
- stockholder; owners
- credit union

Purpose of recent financing (any episode). Postcoded as follows:

01: working capital; operating; line of credit; overdraft; interim; inventory
02: to purchase something tangible - building, equipment, truck, etc.
03: renovation, construction
04: other: e.g., bid and security deposit

Security given in the financing (any episode). Postcoded as follows:
(Two answers allowed).

01: current assets: inventory, accounts receivable, assignment of book debts - Section 86, 88 of Bank Act.
02: personal guarantee
03: equipment, chattel mortgage
04: mortgage on land or buildings
05: shares of the firm
06: floating charge on firms; assets; debenture
07: conditional sales agreement
08: assignment of insurance; cash surrender value of life insurance
09: none - no security given; history and reputation of the company, etc.
10: other

P.6 Verbatim comments on how well institutions have served them. Postcoded as follows:

01: Favourable comments on the institution:
** Long and good relation - 98 years.
** My firm is financially healthy, so I've never had any problems.
Bank kept my interest rate down on a demand loan even after rates had generally risen.
My relationship with the bank is at the head office level - no problems.

One of the firm's directors is an investment dealer. This helps us to get good service and low rates at the bank.
Easier to handle cash through the bank.
Never bounced a cheque.

02: Negative comments on the institution:
** Lack of continuity of bank branch manager is frustrating.
** Bank wants too much security. Bank wants blood. Bank already has my house - why ask for a personal guarantee? Banks are robbing us!
** Bank and FBDB interest rates too high.
Bank is useful in good times, but not in bad.
FBDB takes too long to approve a loan, wants too much security.
** Interest rates in general are too high.
** Bank managers have no business knowledge - out to protect their own interests. Bank not interested in learning about my business.
Bank too slow to get head office approval; not oriented toward serving rural customers.
Banks are not taking risks in the small business area.
Competition from foreign banks may make banks more interested in making long term loans to small business.
Documentation and legal expense to complete financing arrangements are excessive.
If we weren't so good (healthy firm), we could get cheaper financing from FBDB.
** High interest rates are killing me; are hurting my profits.
Bank not cooperative re returned cheques.
Changed banks after five years; service generally not satisfactory.

03: Mixture of positive and negative comments about institutions.

04: Other comments:

I don't need loans. Can finance from retained earnings.
Never asked the bank for a lot.
Shopped for a better rate at another bank.
Need bank financing only when the market for pork slows down.

P.6. Postcoding of institutions mentioned and ranked on the semantic differential scale:

01: Chartered Bank
02: Trust Company
03: Finance company; lessor
04: Manufacturer or dealer from whom the equipment was purchased: GMAC, International Harvester, Chrysler Credit, etc.
05: Suppliers, trade credit

06: FBDB. Sometimes called IDB.
07: Government agency other than FBDB: SBLA, EDP, IEL, ODC, etc.
08: Life insurance company or pension fund.
09: Credit Union or Caisse Populaire
10: Venture capital company
11: Other

P.7. Q.4 (c) (v) Other reasons for turning down short term financing:

Bank did not understand my business and its needs.
Just wanted to shop around and learn the terms of other lenders.
Refused another unsolicited offer because I was happy with the bank.

P.7. Q.4 (d) (vii) Other factors for short term financing:

Allowance for seasonal fluctuations in the level of debt
Personality of the lender
Administration costs
Loyalty to existing finance source

PP. 8 - 9 Other reasons for turning down long term financing or leases:

Wanted provision to accelerate repayment - not allowed
Just wanted to know the alternatives
FBDB took too long
Preferred to use short term bank credit

P.10 Other reasons for turning down equity financing:

Didn't want another partner
Wanted to stay independent
Suspected the offeror did not really have sufficient funds

P.11 Reasons given for refusal by the institution:
Postcoded as follows:

01: Don't know; no reason was given by the lender
02: Financial position or record; inadequate profits
03: Other

Opinion of respondent for the rejection: Postcoded as follows:

01: Wouldn't say
02: Financial position, low profitability or productivity
03: Dispute with the lender - lender was unreasonable, not willing to lend at reasonable interest rates etc.
04: Other: e.g., problems with the shareholders

P.12 Other "related services" used now or potentially used in future:

Bank reconciliation services
Counselling: assistance in assessing investment opportunities in business.

P.13 Others who prepared the budget

Owner-manager; proprietor
President
Management team
External CA

P.14 Q.3: Verbatim responses to difficulties that would be induced by lack of adequate finance over the next three years:

None; no need for new equipment in the next 3 years.
** Restrict growth
Bankruptcy; cease business
Layoff workers
Reduce remuneration of the owner-manager
Wouldn't be able to buy needed new equipment
Dispose of associated companies
Reduce inventory in the store; sell off some assets
Modify trade-in practices (car dealer)
We would work our way down to the lenders of last resort (Alberta Oil Driller)

P.15 Q.4 (b) Other objectives

** No layoffs; well-being of my employees; stable staff size
Feeling of personal satisfaction from work; self gratification
Steady job for normal profit
Good reputation in the business community; be ethical
** Customer service and satisfaction
Continue association with my business colleagues
Do it my way
Bring young people along in the business
Better marketing - expand product line, maintain market share
Increase productivity
Upgrade facilities
Diversification of business operations
Sell Canadian expertise abroad
Turn the company over to my brothers

P.17 Q.1 Awareness of Federal Government assistance:

Employment tax credit
FBDB

Small business development bonds
Small business counselling services
On job training; job experience training
Manpower assistance, manpower training allowance
Loan guarantees
Energy savings
CDIA
DREE
Canada Export Development Corp.
etc.

P.17 Q.2 Provincial Assistance

Varied with the location of the respondent
Small business loans
Industrial Estates Limited, Dept. of Development (Atlantic Prov.)
Hire-a-student
Business advisory services (Toronto)
Ontario Trade Mission
Youth development programmes
etc.

P.18 Q.3 Verbatim responses on what role the governments should play in small business financing and other assistance. Postcoded as follows:

01: more intervention needed to subsidize small business
02: less intervention needed, let free enterprise function on its own
03: both - more in some areas and less in others
04: other comments

Some of the comments were as follows:

MORE INTERVENTION:

** Special interest rates for new businesses starting up, or to finance growth.
** Make financing easier to get; subsidize interest, give priority to small businesses.
Get the unemployed back to work
Direct intervention needed
Help the Canadian Federation of Independent Business. A great organization.
Grants and advice to small business.
I don't know specifically: I'd like to be able to go to one source and get an appropriate package of assistance.
Make used equipment available; encourage leasing.
Encourage wholesale banking.
Facilitate productivity reviews.
Take an equity position for start up or expansion financing.

Help the collection of accounts receivable by setting up some sort of arrangement through the banks.
Assist in the cost of professional services.
Imports are far too cheap; should erect tariff barriers to protect us.
Provide us with more information re the markets in which we compete.
Tougher bankruptcy laws.
Deduct from taxable income any expenditures on expansion.
Redefine small: any business with up to 100 employees should be eligible for aid.
** Extend the income ceiling for the small business income tax deduction; allow more retained earnings before they tax us as a large business.
Develop skill in the work force.
Size should not be the only criterion for assistance.
Help business with a good track record to expand internationally.
Government should guarantee loans for businesses that are solvent but lack the equity to go to the bank.
Restrict interprovincial trade to aid small business.

LESS INTERVENTION:

** Free enterprise can take care of itself. The government should stay out.
Many firms that could afford to expand using internally generated funds accept gifts from governments. This is a waste of money for the taxpayers.
Too much direct intervention already.
The government has wasted money on incompetent business ventures.
Free enterprise must bear risk itself.
Create an infra-structure to foster economic development without direct government intervention.
We regard provincial sales tax as harassment.

OTHER COMMENTS:

** Cut out the red tape, forms to fill out.
** I'm not eligible for aid because I'm not a manufacturer or in research etc.
** FBDB, DREE too slow in assessing applications for aid.
** Government is a bureaucracy, doesn't listen to the real concerns of small business.
The government never helps us, but if we are successful they tax us.
Reduce the penalty for late filing of tax returns and other forms.
Remove Federal sales tax; increase CCA of MURBS.
Stimulate the work ethic.

Standard policies are not appropriate for specific problems.
Too much emphasis on larger, more established companies.
Assistance is after the fact, not when really needed.
Personnel in the tax department are very rude to us.
They should give us longer to pay Federal and Provincial sales tax withholdings.
We no longer get information on the assistance programmes to small business.
I've been in business 26 years and I'm still not aware of the programmes.
Government tries to apply theory to practical issues.
The Provincial, not the Federal Government should help me, because I employ a lot of people in this province.
Unsecured creditor should be entitled to share in bankrupt firm's assets.
They tax the successful business in order to support the ones with problems.
It's not worth the cost and bother to go through the red tape involved in applying for government assistance.
Recently, we had a consultant come in and review all the assistance programmes in order to assess whether we were eligible for aid.
Government should clean up its own house first.

P.18 Q.F Any other comments on the survey or on small business financing in Canada in general? Postcoded as follows:

01: generally negative comments on governments or on financing experience
02: generally positive comments on governments or on financing experience
03: other comments, on the survey, on governments or on financing experience.

NEGATIVE COMMENTS - EXAMPLES:

Soon I'll have to sell out, because the big firms are squeezing me. Government should protect me from this.
When small business needs financing no one is willing to help.
Many competent people are wasting time due to lack of resources to develop their potential.
Only industries with lobbies in Ottawa get good financing.
Banks are too conservative; ignorant of needs of small business.
Small business can't afford to hire full time advisers to fill out the forms etc., so might as well do away with them.
Lack of protection of small businessmen as unsecured creditors.
I distrust both governments and banks.
Banks are like a club: they gang up on you.
Bank staff turnover is a big problem for us.

Lending institutions are too impersonal; never get to know you.
I'm penalized because I'm not a manufacturer.
I can only get money if I already have some in the bank. It's a joke.
Tax laws are unfairly tough on small business.
Interest rates are strangling us.
FBDB is so expensive and we get nothing for it.
FBDB is unwilling to lend to service industries.

POSITIVE COMMENTS:

** We have never had any financing problems.
Main problem is uncertainty re general economic conditions, not financing.

OTHER COMMENTS:

** I like the study. Maybe it will help small business; may help change government policy.
I enjoyed participating. Forced me to take a broader perspective.
I don't think we really qualify for the survey, because we are not treated as a small business on our taxes.
Would like educational seminars for small businessmen.
More information and coordination of the programmes is needed.
More emphasis on lease financing needed; better communication of cost of leases.
Interest rates hurt the growth of small business dramatically.
** Government aid should not be squandered: right time, right place, right amount.
Canadian businessmen should be more aggressive.
Canada needs merchant bankers.
With all the bankruptcies, maybe small business is getting too much credit already.
Budgets are for the big guys. If somebody gives me a $200,000 order, then I got a budget.

P.19 Interviewer's comments:

Interviewers were asked to make any comments they felt to be appropriate on the business or its management, as if they were considering buying shares in the company. Quite often, they said they thought the business was well run, or that management was "on the ball." Sometimes, they made other comments on the special nature of the business or its environment. Such answers were postcoded as follows:

01: Well run business; management on the ball.
02: Other comments
Else blank.

OTHER COMMENTS:

Owner will ask his accountant for better planning as a result this interview.
Slowness of banks to approve loans has forced the business to lean on its creditors.
Personal guarantees are far in excess of what is owed to the bank.
Firm with $8,000,000 sales would build a new plant if mortgage rates were lower.
Lawyers and accountants far too expensive.
Lack of privacy during the interview. People kept butting in.
Mr. X pays out all of the firm's earnings as salaries, so corporate tax laws do not affect him.
Owner despises unions. Sold a previous firm just after a union was certified.
Banks only look at the figures. Gave no advice or assistance to this firm.
Owner was surprised that banks had not shown more interest in the business. Maybe foreign banks will be more interested.
Respondent was unaware of financing alternatives.
The respondent is exposed to considerable risk on his receivables, whereas the bank is fully secured.
The business will undoubtedly be wound up after the owners retire.
Respondent complained that government agencies took too long in assessing an applicant for aid.

Some Concluding Remarks

Many of the verbatim responses noted previously are no doubt specifically related to the particular circumstances facing the respondents. Others, distinguished by asterisks, were mentioned repeatedly. It is hoped that the tabulation above will give the reader an appreciation of how the questions were answered and of the breadth of financing problems facing small businesses in Canada.

Chapter 5

FINANCIAL AND TRUST COMPANY SENIOR EXECUTIVES SURVEY ON SMALL BUSINESS FINANCING

by
B. Kalymon

Introduction

The purpose of the Senior Executive Survey was to provide an initial overview of the activities and concerns of the non-bank financial institutions in the area of small business financing. Of particular interest would be the role of government regulations, programs and institutions in influencing the participation of the NBFIs in such markets. Additionally, the determinants of corporate policies would be identified to provide guidance on the way that corporate behaviour would likely evolve or could be affected. Finally, the future trends in the industry which would be likely to impact on the financing of small business were assessed.

The approach taken was to develop a questionnaire which was used in personal interviews at cooperating institutions (see Appendix C (i)). The institutions and executives who participated in this initial survey are described at the end of this chapter. These institutions were chosen on the basis of recommendations from the private sponsor RoyNat, the Association of Canadian Financial Corporations, and the Trust Companies Association of Canada - as well as on the basis of their known activity in the field. Representation ranged from high to low levels of participation. Time restrictions dictated that only lenders based in Toronto, Montreal and Quebec City were included, though most operate on a nation-wide basis. Lack of commitment to participation in the study resulted in the exclusion of other NBFIs such as pension funds or insurance companies from the sample. The Canadian Co-operative Credit Society became a sponsor of the study after this project was completed.

At each institution, the senior executives with responsibilities in the area of small business lending were interviewed. In smaller institutions, this senior executive was the president and chief executive officer. In larger institutions, a senior vice-president and the manager of small business lending were interviewed. Their opinions were documented on a confidential basis and shall be reported without specific identification.

All interviews were conducted by Professors B.A. Kalymon and J.V. Poapst in August and September 1980, and the report was prepared at that time.

The initial section of this report outlines the general perception of the small business financing market revealed in the interviews. The second section focuses on the current involvement in small business financing of

NBFIs interviewed. The nature of the alternative institutions participating in small business financing is discussed in the third section. The main policy considerations determining institutional involvement in small business financing are outlined in section four. Attitudes towards government regulations, programs and institutions are presented in the fifth section. In the last section, the main trends and concerns for the future are summarized.

General Perceptions of the Market

For the purposes of this survey, firms with annual sales below $25 million were defined as small. Almost unanimously, the senior executives of the NBFIs believe that in general the financing needs of small business are being adequately met. The typical responses were that:

> Anyone who has a reasonable proposal can get money on reasonable terms.
>
> Small businesses have proportionately as much or more debt than large corporations.
>
> Money is available, but its cost must be high to reflect the high administrative costs and credit risks of the small business.
>
> If a borrower meets the proper credit criteria, he will obtain financing.
>
> Financing has been shown not to be high on the list of importance to small business.

In summary, the weight of the expressed opinions is that the small business with a well-conceived and realistic financing need is properly serviced and is, in fact, eagerly solicited by a variety of lenders.

However, when asked if any "gaps" do exist in the financing of small businesses, several areas were identified. The most common reply was that a possible "gap" exists not in the area of lending markets, but in the equity markets. The suggested point of view is that a lender, given his sources of funds and operating procedures, cannot provide funds which would be exposed to substantial default risks. Lenders thus restrict themselves to lending well secured by marketable collateral or well within the safety margins of debt carrying capacity. For such financing, adequate supplies of funds are available and lenders compete aggressively for the available loan demand.

Beyond the financing needs which can be served by essentially risk-free lending, the small business must seek equity financing. This market was generally acknowledged as being poorly developed with an insufficient level of available venture capital. Some comments offered in this regard included:

High risk businesses cannot attract financing.

There is not an adequate incentive to encourage equity investment either for private venture capital firms or institutions.

Finance companies were once willing to accept some equity risk when they enjoyed a 6% spread.

The customer base for high risk loans which were priced at 5% above prime was too small.

The performance of venture capital firms has been poor.

Canadian firms are too highly leveraged and under capitalized. Tax incentives and profit opportunities are lacking in venture capital markets.

Such remarks generally suggest structural problems in the area of equity financing.

Additionally, several executives identified some business sectors in which financing is particularly difficult. Retail businesses, restaurants, recreational businesses and other service sector businesses were singled out as examples with poor collateral to offer. The basic assets required in these businesses generally have little value in the event of liquidation. Again, the nature of the financing required is high risk debt or equity.

A final area of repeated comment related to the possible "gap" is the smaller term loan area. None of the surveyed institutions is interested in loans below $20,000. While equipment financing companies are interested in the $20,000 to $100,000 range, these must generally be highly standard loans against specific collateral. Participants in more general term lending to small business are interested only in loans above $100,000 as the smallest term loan of interest. Generally cited was the high fixed costs of administering a loan which, for a fixed rate, makes the larger sized loans much more attractive.

The preceding overview suggests that market "gaps" may exist in businesses which can be classified into one of five categories:

1. Lack marketable fixed assets to offer for collateral security.
2. Are involved in the high risk service sectors.
3. Are in a start up situation and have not established managerial skill.
4. Are too small to require funding above $100,000.
5. Are under capitalized and require additional equity funds.

Economic reasoning suggests that the cost of funds to such businesses must be high as risk rises and economies of scale in administration decline. While some senior executives interviewed expressed the opinion that

"What is currently not financed is not worth doing,"

others suggested that potential structural weaknesses exist in financial markets in these areas which are partially being met through government programs.

The possibility of private lenders filling the identified "gaps" appears to be limited. If the "gap" is based on a fundamental excess of costs over available revenues, no private lenders will enter without a subsidy. In this context, the current losses in Federal Business Development Bank (FBDB) operations and poor profitability of venture capital firms in general was cited and the lending activities under the Small Business Loans Act was characterized as a "loss leader" or "cross-subsidized for purposes of public relations." While the desirability of social subsidies for these "gap" areas was questioned, government intervention was recognized as the only possible source of remedy.

Current Involvement

The lending activities of the trust companies and the financial corporations in the area of small business are currently very much in a state of evolution. Each type of organization appears to be broadening its lending beyond the boundaries of its traditional role. All interviewed lenders see themselves as having a role as term lenders to small business, but only a single institution indicated any participation in equity financing.

Trust Companies

All of the trust companies reported mortgage lending as their main financing activity for small businesses. While most trust companies could not readily identify the portion of their industrial and commercial mortgages which were granted to small businesses, the volumes were considered to be substantial relative to any other product line. Mortgage lending was defined as a loan secured primarily by the value of real estate. Such loans generally carry a term of five years, at fixed interest and with a long amortization period of up to twenty-five years.

Term lending to small businesses by trust companies has evolved from pure mortgage lending. Often real estate is still the principal collateral provided, but other collateral in the form of chattels or general liens may also be included. The prime distinction which is made in a term loan as compared to a pure mortgage loan is that the former is granted mainly on the credit capacity and cash flow of the business rather than on the collateral provided. The credit analysis required for the granting of term loans is substantially more complex than in mortgage lending and most trust companies are only beginning to acquire the personnel required for this activity. The reported term of such loans ranged from four to seven years with either fixed or floating interest rates and longer amortization periods.

The significance of such term loans is still very small to the trust organizations interviewed with total outstanding loans ranging from $70 million to zero. This should be contrasted with the total assets of the firms interviewed which ranged from $7.1 billion to below $1.0 billion.

The only other lending activity directly within trust companies appears to be in interim financing for builders. This appears to be the only area of trust company activity in the short term lending markets and is generally linked to their mortgage lending activities.

Outside the financing activities indicated, the trust companies generally offer the following services to small businesses: term deposits, pension fund management, property and estate management, stock transfer services, personal financial planning for management and other trust services. Trust companies do not generally provide current accounts for small businesses since they cannot offer lines of credit. With the above noted exceptions, small businesses are not in extensive contact with trust companies.

Small business loans in trust companies originate from several sources. Internal referrals from mortgage lending or from the branches initiates some term loan applications. Referrals from professional advisors including lawyers, chartered accountants or brokers are often the sources. One large firm uses the services of an outside, brokerage-house related company to both develop prospects and provide credit screening and administration.

Lacking extensive commitment to general small business lending, all interviewed organizations still have only very skeletal organizations for term lending activities. While the larger trust companies generally operate with a large number of branches, ranging from 52 to over 200 in our interview sample, the number of term lending offices is generally restricted to a small head office group. While term loans may originate almost anywhere across the country, assessment and approval would have to be processed within the head office group. Several organizations commented on their current attempts to develop a more extensive network of loan officers capable of dealing with term lending. Most are still only experimenting and are awaiting organizational commitment to the extensive development efforts which would be required. These are seen to be justified only if substantial volumes of business would be forthcoming.

Financial Corporations

The principal activity of all interviewed financial corporations centred on equipment financing in the forms of final sale equipment loans, equipment dealer inventory loans or equipment leasing. Such activities accounted for a range of 95% to 56% of the total assets of companies interviewed. These financial corporations are however of smaller size and in our sample had total assets ranging from $94 million to $704 million.

The average equipment loan is secured by equipment as collateral. While lenders consider the credit position of the borrower, the collateral is viewed as providing the basic security. Higher ratio equipment loans (up to 80%) are now possible, compared to the historical past, because future resale values on equipment are providing greater protection to the lender. The term and amortization period of the loan is generally around four years and relates to the useful life of the equipment. Most of the loans appear to be centred on automobiles, trucks, construction equipment and aircraft with the remainder in moveable machinery ranging from printing presses or computers to mining equipment. Amounts of total outstanding equipment loans ranged from $32 to $290 million.

Associated with equipment loans are inventory loans to dealers of equipment. These are short-term loans of 60 to 90 day average duration secured by equipment inventory. Such dealer inventory loans are particularly important to so called "captive" credit corporations who, on occasion, provide subsidized financial support to the independent dealers of the parent company products. In effect, such financing is a form of supplier credit for major equipment inventories. As a result, independent financial corporations appear to be somewhat less active in this area.

The leasing activities of the financial corporations are similar in volume to equipment loans and in fact are viewed as offering essentially the same service only with alternative taxation implications. Under proper lease arrangements, the lessor gains the benefit of the capital cost allowances and tax credits provided. Borrowers with little taxable income or low rates of taxation could, in effect, transfer unusable tax-write-offs to the lessor. Changes in the taxation provisions are currently restricting the write-offs to the amount of leasing income. The amount of assets committed to leasing to small businesses by financial corporations ranged from $2.2 million to $244 million, but appears not to be expanding.

Similarly to the evolution in trust companies from pure mortgage lending to term loans on a commercial basis, the financial corporations are also attempting to establish term lending as a "package loan" or "capital loan" financing service for small businesses as an outgrowth of equipment financing. The amount outstanding in such lending represents only a small fraction of their assets and ranged in total volume from several loans to $5.4 million. While generally expressing an interest, several respondents cited unsuccessful past experiences in attempting to develop this lending area.

Financial corporations generally offer no other services to small businesses with the exception of general counselling related to loan negotiations. Their methods of business organization include direct sales force solicitations, mailing and advertisements in trade journals, promotion with dealers of equipment, some linkages with manufacturers and general client referrals. For term lending, some referrals are provided by banks or professional financial advisors. The larger companies operate between 10 and 20 commercial lending offices located across Canada, while smaller firms are regional. In comparison with trust companies, the financial corporations have larger numbers of personnel trained in term lending, or at least experienced in dealing with small businesses through equipment lending.

RoyNat

The acknowledged largest non-bank term lender to small business is RoyNat. Its portfolio of assets is centered on term loans ranging from four to ten years in maturity with even longer amortization periods. Its annual volume is currently around $350 million with an outstanding total of $915 million. While land, plant and equipment are generally taken for security, the cash flow or earnings of the business are generally the prime consideration in granting loans. Quality of the management and collateral given are the other prime determinants of the credit decision. Active expansion of these term lending activities is being pursued.

Its procedures for developing loans is not dissimilar to those used by other financial corporations. Additionally, RoyNat has relied on some referral business from its parent organizations. Given the competitiveness of the market, sales training is provided to its representatives. Approximately 29 offices are maintained and these are located in every main centre of the country. Highly qualified lending officers, generally with C.A.'s or M.B.A.'s, are required for the type of lending in which RoyNat specializes. Its existing capacity in this regard is considered a prime promotion vehicle, but expansion can only be achieved gradually.

Sources and Cost of Funds

The financial cost of funds to a small business in competitive capital markets will be determined by consideration of the cost of capital to the lending organization in conjunction with the mark up or spread required for small business loans. This spread is determined by the costs entailed, primarily: the loss-ratio of a particular lending activity and the administrative costs involved. These basic three components will determine, in the long-run, the rates at which small business loans will be made in the absence of non-competitive influences in the financial markets.

Trust Companies

The trust companies interviewed were Canadian controlled and, with the exception of one company, act as independent publicly owned corporations. The larger companies are involved in a variety of subsidiaries including companies in interim financing, data processing, factoring and insurance among others.

The main sources of funding of trust companies are term deposits which ranged from 58.4% to 90.0% of the total liabilities of our sample firms. These are generally issued for terms ranging from one to five years at fixed rates of interest. The second most important source of funds are savings accounts and other demand deposits which accounted anywhere from 3% to 36.9% of the liabilities of the sampled firms. In combination, these deposits provide a high degree of leverage to trust firms with deposit to capital ratios ranging in our sample from 18.4 to 26.5.

Given the high degree of leveraging, the cost of funds to trust companies is determined by the cost of deposit money. The general range of costs of combined demand and term deposits appears to be in the range of 1 to 2% below the prime rate in the market. Recent shifts in prime rate have left trust companies with a wide range of average book costs depending on the maturity structure of their liabilities.

Financial Corporations and Others

With the exception of a single company associated with one of the trust companies and the major term lender, all of the sampled financial corporations are directly or indirectly subsidiaries of large U.S. corporations. These parent organizations generally guarantee the debt or notes of their subsidiaries facilitating the raising of capital.

Without direct deposit taking powers, financial corporations rely on the issue of corporate paper and bank loans for short term funds and on bond issues for long term funds. In the case of corporate paper, it was found to provide between 29% and 56% of the total funds of traditional financial corporations, while the major term lender relied much less on such sources. Bond issues were found in the sampled firms to account for a range of 26% to 47% for traditional financial corporations while providing the major firm lender with 72% of its total funds. These long-term bonds often have maturities of over 10 years and are sold through both public and private placements. The usual buyers of these bonds are insurance companies and pension funds. Some access is provided to Euro-dollar markets as well for bond placements. The leveraging of financing corporations is generally restricted at the upper range by the financial markets in which their obligations are sold and the sample the debt to equity ratios ranged from 2.2 to 12.5.

The generally expressed opinion was that due to the lower leverage available and the need to rely on larger financial intermediaries, including banks, the cost of funds for financial corporations exceeded that of both trust companies and the even more highly leveraged chartered banks. While corporate paper of financial corporations generally sells at 1% to 1.5% below prime, interest rates on long term bonds recently have usually exceeded the prime lending rate. With lower leverage, and high return expectations on invested equity capital, the average cost of new funds to a financial corporation substantially exceeds that of trust companies or banks. Again, reported average costs of these corporations generally reflect historic decisions regarding long term debt rather than current marginal costs.

Required Spreads

Given the nature of the risks and costs in loans to small business, the senior executives stated that a spread of 2 to 4 percentage points is required for profitable lending. Even this range was questioned by some as providing too narrow a range for smaller or riskier loans which in the past permitted spreads up to even 8%. Given current market competitive conditions, most participants are experiencing a squeeze in obtainable spreads. An average of 2.5% was cited for larger term loans and possibly 3.0% in smaller equipment leasing financing.

The effective costs of term loans to smaller businesses today appears to be in the range of prime plus 1-2% for larger loans and prime plus 3% for smaller loans. Most participants from NBFIs, however, expressed the opinion that the chartered bankers, the foreign bank affiliates and the FBDB, all contribute to a generally insufficient spread due partly to their lower cost of funds and also to either a lack of market experience, to "penetration" or volume orientation or to public subsidization.

Matching of liability and asset maturities has been weak in most of the institutions interviewed and has resulted recently in either losses or a decline in profitability resulting from the sharply increased general level of interest rates. The ability to attract long term deposits has declined and shorter term investments or ones based on floating rates of interest are being sought.

Competitive Policy Considerations

The factors which shall determine the degree of corporate participation in small business financing are varied across corporations. The dominant factors from the viewpoint of the trust companies appears to be in the area of regulatory restrictions and lack of experienced personnel or administrative structures. Of most critical importance to financial corporations appears to be their high cost of money and consequent lack of sufficient spreads. All institutions cited unacceptable levels of risks as the prime determinant in avoiding involvement in equity financing. Lack of sufficient loan demand was cited by over half of the survey participants as a major deterrent given the competition from the chartered banks.

Often cited by trust company executives was the need to improve the matching of their liability term structure. Term lending on a floating rate basis was seen as a possible matched use for deposits with shorter terms. The general current depositor shift away from five year Guaranteed Investment Certificates was cited. In addition, the declining opportunities in mortgage lending markets appears to be motivating the search for alternative product lines.

The encroachment of the chartered banks on several of the historic markets of the financial corporations such as the consumer lending and more recently equipment loans and leasing markets, appears to have limited the confidence of financial corporations in being able to compete in term lending. Their general comments suggested the adoption of a position of high specialization and general retrenchment. While the existence of government programs was cited by some, the relative importance of this consideration in policy determinations appears to be generally weak. Even the existence and activities of FBDB were considered to be relatively unimportant to most interviewed executives.

In assessing their competitive position in small business lending markets, the senior executives invariably commented on the dominant position of the chartered banks. Their high leverage factors, in the order of 30:1, and access to relatively inexpensive deposit funds provide a cost of funds which cannot be matched by other participants. Their total size and the extensive branch networks which they operate provide banks with first access to most lending opportunities. The Banking Act is seen as providing the chartered banks with unlimited power to enter any market through subsidiaries and further extensions of direct powers are foreseen. The extensive list of bank provided services to small businesses, in particular current chequing accounts and the provision of an operating line, are seen as almost unsurmountable barriers to entry in small business lending.

Nevertheless, the lack of specific banker experience in term lending and the generalized training of local bank managers is cited a a competitive disadvantage for banks which creates opportunities for other term lenders.

The foreign bank affiliates are generally viewed to be uninterested in the small business sector and tend to compete only in the upper size range of term lending. Their activities in recent years are viewed as leading to the reduction of spreads to unprofitable levels in larger term lending. This behaviour is seen as temporary and resulting from their need to establish sizable loan portfolios in anticipation of changes in the Bank Act.

Traditional financial corporations are perceived to be generally in difficulty and unable to compete due to their lack of leverage and restricted size. Experience in equipment term lending appears to be the prime competitive advantage enjoyed by these corporations. A higher degree of understanding and flexibility due to more specialized services is permitting the continued existence of such institutions in the face of greater bank interest and penetration into their market.

The trust companies while more highly leveraged still have a higher cost of funds relative to the banks. While proposed changes in the Trust Company Act are seen as removing the most critical restrictions on their investments, historically, trust companies have been limited in their flexibility in participating in business lending. Consequently, most lack experienced term lenders and are not active in such markets.

Insurance companies and pension funds have traditionally been constrained in their investment portfolios similarly to the trust companies. Their activity in term lending is currently quite limited. Their source of funds is long term and perceived to be relatively inexpensive. Some recent interest in term lending appears to be related to a slowdown of opportunities in traditional mortgage markets.

Government Regulations

As noted earlier, the interviewed senior executives did not generally rank either government regulations or programs as very important to their policies on small business lending.

For trust companies, the most commonly mentioned regulations which affect their participation in small business financing were the following:

1. Trust Company Act restrictions on eligible investments.
2. The limit of 7% on lending not subject to the normal restrictions (i.e., basket clause lending.)
3. The lack of provision to permit inventories or accounts receivable as collateral.
4. The restriction to 20% of capitalization on loans to eligible borrowers.
5. The distribution of investment requirements which require that 75% assets must be in mortgages.

Most of these regulatory restrictions are expected to be remedied with the proposed changes to the Trust Company Act, with the exception of the taking of the inventory or accounts receivable as security. Furthermore, most lenders do in fact find technically qualifying categories for most of their current potential loan business.

Undoubtedly, of major concern and limitation to all participants in leasing are the recent changes in taxation regulations which prevent the application of capital cost allowances against other than leasing income. This change in regulations has effectively destroyed the growth of lease financing since many corporations lack sufficient taxable leasing income. Of particular value to smaller firms lacking high tax liability, the lease arrangement performed somewhat the same function proposed under the small Business Development Bonds in that non-taxable income was provided to lenders resulting in lower effective interest costs to borrowers.

Outside of the area of leasing, the financial corporations feel few direct restriction from government regulations. Indirectly, however, several commented on the lack of government restraints on the chartered banks which has led to the dominating position of banks and the potential elimination of competitors in term lending.

With regard to government institutions and programs, the following comments on their impact were offered:

<u>Federal Business Development Bank</u>

They do not act as lenders of last resort and are very competitive.

Serves to discourage new entries in term lending and indirectly contributed to the demise of Norco which lasted only five years.

They tend to tie up company's assets and are not receptive to disposing of loans when a take-out is possible.

The rates are subsidized as can be seen from recent losses and limit the profitability of private lenders.

Recently, are being forced more into the smaller enterprises and into hotels, restaurants and the recreational sector.

High loss ratios indicate that many of the loans should not be made.

Despite such opinions, most executives interviewed do not see FBDB currently as a direct competitor. The possible role for FBDB is seen mainly as a guarantor of high risk loans or as an operator in the small size loan area which cannot be dealt with profitably.

Small Business Loan Act:

Loan size limit of $100,000 is too restrictive.

The rate limit of prime +1% provides insufficient spread for the lending to be profitable.

We are registered lenders but have not granted any loans due to the lack of a trained network of lending personnel.

Banks are making such loans only due to moral suasion.

While definitely unprofitable to the financial corporations, the program is being actively considered as an area for expansion by two of our sampled trust companies. Generally, the program is considered favourably structured, but too limited in loan size and rates permitted.

Small Business Development Bonds:

We are doing as much as we can under the program and it has been well received.

With the program due for early expiration and approval still uncertain, it is too short-lived to justify the required personnel training.

An interesting concept but a lack of taxable income currently restricts our participation.

It was an idea which provides advantages only when interest rates are high.

Substantial confusion exists as to the definition of taxable income which will be used.

Of our sample, only a single respondent chose to participate in this program which appears to suffer less from concept than from implementation delays and intensive confusion as to the provisions of the Bonds or even their very existence.

Enterprise Development Program

The partial nature of the guarantee (90%) will not qualify these investments under the Trust Company Act as secured investments.

> We feel that financial institutions should not be completely taken off the books, since they will look closer if guarantees are only partial.
>
> The administration of the program is poor and extensive delays have been experienced.

Of the sampled institutions, only two had any participation in this program. Most respondents were totally unaware of its existence.

Department of Regional and Economic Expansion (DREE) Grants

Only a few respondents have had any involvement in DREE supported projects and most do not see DREE grants as an important factor in the market. One executive commented on the distortion in security value created by the existing possibility of obtaining DREE grants for new plants in a given area.

Provincial Loan Guarantee Programs

> Complex paperwork is generally required and a single deal once required eight months.
>
> Guarantees at low interest rates are unattractive due to lack of profitability.
>
> The most interesting programs are ones with interest rebate features.

Generally viewed as highly marginal areas of lending activity, several interviewed institutions had participated on occasion. Generally preferred to direct lending activities which exist in most provinces.

General attitudes of most interviewed executives may be summed up by the following quotation:

> We generally prefer to avoid involvement in government programs; often these have been found to be poorly administered and result in poor business.

When asked to identify what new possible government programs would be of interest, most respondents suggested some form of a guarantee program with the following observations:

> A guarantee program would undoubtedly result in high losses requiring government subsidies.

Previously introduced Credit Re-Insurance Program failed to materialize, since the market would not accept the 1% per year premium required.

Any system to be introduced should avoid duplication of credit review and effectively several layers of underwriting since control time becomes excessive.

For government insured loans, pension fund monies would be readily available.

Term lending insurance is not as easily put into a formula basis as is done in mortgages by MICC, yet MICC is currently facing high losses.

A potential exists for using the FBDB as a loan guarantee institution and reducing the level of government funding provided.

More room should be provided for private lenders by reducing the participation of FBDB as a subsidized lender.

While difficulties were generally cited most interviewed executives generally felt that a workable program for loan guarantees is possible. Such a program was generally held to be of more importance to the trust companies and other legally restricted lenders since most financial corporations would most likely find guaranteed interest rates too low.

Future Trends

The current intentions of each institution with regard to future activities in small business financing were surveyed. While few had formulated any specific targets for volume of business, general directions were indicated.

Of the trust companies, one clearly indicated no intention in the near future of entering the small business lending market and a strong preference to concentrate on large business loans in their commercial portfolio. One expected to continue to expand its term lending activities rapidly with a possible rate of growth of 25-30% annually. One of the companies was currently in the experimental stage of developing a small business loan portfolio and further commitment would depend largely on the experience gained. The fourth company had no current plan to enter small business lending but would be interested in the event that a suitable guarantee program was developed.

For the traditional financial corporations a similar diversity in plans for the future was identified. One of the firms intends to remain strictly in its current product lines related to equipment financing and grow with the market. A second firm is in the midst of a major review of its strategic commitments and product lines with current considerations being given to retrenchment from pure lending activities and creation of a more service oriented product for small businesses including collection services, sales training, data processing and education. A third organization is interested in expanding its term lending activities, but feels that the current competitive advantage of the banks cannot be overcome. Two organizations indicated that they are actively recruiting personnel to expand their term lending activities and future volumes will be determined by loan demand.

Most organizations interviewed expect to retrench from leasing activities due to the lack of sufficient leasing income to take advantage of capital cost allowances. Several indicated a need and intention to expand in oil and gas lending to small firms in the West. No particular other sectors or stage of business development were indicated as a target for expansion of lending activities. Most commonly, the future rate of expansion would be limited by the rate at which experienced personnel can be trained, a significant problem area for all organizations interviewed.

The general trends for the future in small business financing indicated by the senior executives can be described by the following quotations:

> Banks are entering financial company term markets and destroying competition by size, cost of money and unfair practices.
>
> Banks will become increasingly competitive in term lending.
>
> There will probably be a fallout in financial corporations due to the increased powers of the chartered banks which resulted from the 1967 and proposed current revisions of the Bank Act.
>
> The Bank Act will not increase the competition, since there will be fewer participants.
>
> Constant innovation and seeking of new markets will be required.
>
> Traditional financial corporations will find leasing and equipment loans eroded by the Banks.
>
> Capital finance companies will decrease in importance due to more aggressive competition in financial markets.

Trust companies are not yet ready for a major move into term lending.

FBDB monopoly of the 40's and 50's is declining as it is forced to pay market rates of interest for its funds and it shall be moving to retail and lower level loans.

Clients will want diversification of sources and seek longer amortization.

The small business loan market will grow at 20% per year.

A shift in money supply from long term to short term will force lending to be at floating rates and shorter maturities.

With the shrinking of the residential mortgage markets and new lending powers the trust companies will become more active.

The capital needs for business financing will be a high growth area in light of the major pipeline expansions which are to be undertaken.

Inflation may require changes in the way high interest rates shall be charged with possibly more emphasis on income debentures.

In conclusion, the general prognosis of most senior executives is that the small business lending market will clearly provide a growing opportunity for investments. Nevertheless, intensive competition is expected for this market, particularly from the chartered banks. Changes in the structure of the market shall realign the participants and the form of lending contracts. Inflation shall continue to dictate high rates of interest.

Exhibit 1

LIST OF EXECUTIVES INTERVIEWED

	Type of Company	Head Office Company	Approximate Total Assets (million)	Position of Executives
A.	Trust	Quebec City	$ 100	Executive Vice-President and General Manager
B.	Trust	London	$6,000	Chairman of the Board Group Vice-President of Finance Assistant Vice-President of Corporate Lending
C.	Trust	Toronto	$2,000	Senior Vice-President, Corporate Financial Services Vice-President, Corporate Lending and Leasing
D.	Trust	Toronto	$7,000	Vice-President and Treasurer Manager, Treasury Administration
E.	Financial Corporation	Toronto	$ 200	President
F.	Financial Corporation	Toronto	$ 600	President
G.	Financial Corporation	Hamilton	$ 600	President
H.	Financial Corporation	Toronto	$ 100	President
I.	Term Lender	Montreal	$ 700	President and Chief Executive Officer Senior Vice-President Assistant Vice-President, Corporate Planning

Chapter 6

FINANCIAL AND TRUST COMPANY PRACTICES IN SMALL BUSINESS FINANCING

by
Len Fertuck

This chapter was designed partly to parallel and partly to extend the Senior Executives Survey reported in Chapter 5. That survey dealt with broad policy and strategy considerations as seen from the top of the companies. This study explores small business financing by NBFI's at the operating level. The chapter has two main parts. In Part I small business financing is viewed through the eyes of loan officers and in Part II through a survey of financing files.

I. Survey of Loan Officers

Method and Scope

Data were gathered by administering a questionnaire (Appendix C (ii)). For the purpose of this survey, independent firms with sales below $25 million were defined as small. Personal interviews were conducted with the senior loan or mortgage officer in each of a sample of 36 offices of 19 firms in the cities of Vancouver, Calgary, Saskatoon, Winnipeg, Toronto, Montreal, Quebec and Halifax.

The sample is not scientifically stratified since no effort was made to obtain proportional representation geographically or by industry sector or volume of financial transactions. However, an attempt was made to obtain representation in as many different market segments as possible ranging from local specialists such as a financial broker, a medical equipment leasing firm, an aircraft leasing firm and two auto leasing firms to a number of large national term lenders, trust companies, and leasing firms.

More time and resources would be required to implement a good stratified sample, since it is very difficult to determine which firms are involved in commerical lending. SB Capital has a directory of financial firms, but it is somewhat incomplete and provides no information about the volume which each firm handles or where its branches are located. The telephone yellow pages are also an imperfect guide since many listings are for personal financing. There appears to be a real need for a good directory of lenders to ease the borrower's search for financial sources.

The cities in which interviews were conducted were chosen for their national representation and for comparability with the Survey of Small Business Financial Managers (Chapter 4). No interviews were conducted in Kitchener and St. John, which were sampled in the "demand side" study, because of the limited availability of firms in the area. Apparently most of the financing in these areas is handled by banks or regional offices of NBFI's in nearby centres.

The firms were generally very cooperative in providing interviews. Only three loan officers refused to participate in the study when approached over the telephone. About six others could not participate because of schedule conflicts, but would have been willing to participate if we had been available at other times.

The person interviewed was generally either the loan manager for the office being sampled or one of the loan officers in the office. In a few cases, both the manager and one of his subordinates were present for the interview. In cases where a firm is involved in both equipment and real estate lending, the questionnaire was administered twice to gather separate data about the two segments of the business. Such interviews were counted as only one interview in the total of 36, but may appear as two interviews in statistics presented later in the report.

If the sample of firms is biased, it is most likely to be biased towards underrepresentation of the wide variety of specialized firms which are found only in the large centres of Toronto, Montreal and Vancouver. Another source of bias occurs in the smallest centres where banks and credit unions tend to have a large share of the market because the other lenders do not have local offices. However, the national firms usually do attempt to serve the smaller centres regularly by visits and telephone contacts from the nearest regional office.

The Competitive Environment

The firms can be broadly grouped into two categories. One category deals primarily with long term equipment loans and leases. The other category deals primarily with long term mortgages and real estate leases. Totally unsecured term loans to small businesses are very rare and very few firms are willing to provide such loans. So-called "term lending" usually relies on a debenture approach involving such devices as negative pledge clauses. Firms which specialize in short term loans by financing inventory or factoring receivables were not sampled in this study.

The firms differentiate themselves by the type of security which they specialize in rather than by the type of financial instrument which they use. Thus, a firm which finances equipment will generally make secured loans, lease the equipment, or use an installment contract depending on the needs of the customer. Similarly, a firm specializing in real estate frequently provides both mortgages and leases.

Within each category, there is much specialization by type of security taken. Equipment firms exist which specialize in construction equipment, aircraft, railroad rollingstock, cars or trucks, computers, medical equipment, office equipment, restaurant equipment, logging equipment and various other equipment. Similarly, the real estate mortgage and leasing firms only deal in one or a few of various classes of security such as factories, warehouses, office buildings, apartments and residences. Thus, while there are a large number of financial institutions in the market, each competes only with a few others for a specialized market.

This high degree of differentiation results from the need for specialized knowledge of the market. The lender cannot realistically assess the risk of a loan without knowing the resale value of the security being offered and the likelihood of his client succeeding in the proposed business venture. A detailed knowledge of the client's industry and the market for his equipment is needed and only a specialist can afford to acquire such knowledge.

The degree of competition depends on the industrial sector of specialization. Competition is strong in the area of equipment leasing. The market is served by a number of national companies which include:

- Canadian Acceptance Corporation
- Canadian Financial Company
- Commerical Credit Corporation
- Genelcan
- RoyNat
- Traders Finance
- United Dominion Investments Limited

Loan officers from these companies frequently mentioned competition from both the domestic chartered banks and foreign banks. As expected, competition is strongest in the large centres like Montreal, Toronto, Winnipeg and Vancouver where, as one loan officer said, "there are hundreds of competitors." In smaller centres such as Saskatoon, Quebec and Halifax, the number of competitors is much smaller, but competition is still strong since all of them are competing for a smaller customer base. They are also frequently competing with regional institutions such as Northland Bank in Saskatchewan or Laurentide Financial Corporation in Quebec.

There was a general feeling that the chartered banks would become very strong competitors in the near future now that they have the power to compete under the new Bank Act. However, several loan officers felt that the banks were having trouble exploiting the advantages of a large number of branches and a ready supply of money. The chief difficulty is apparently a lack of qualified staff and a lack of experience in the evaluation of assets. This difficulty may be expected to diminish with time. Nevertheless, 23 out of 34 officers mentioned chartered banks as strong competitors. Those that did not tended to be in trust companies or specialized lenders such as auto leasing.

The foreign banks were mentioned only occasionally and then only in certain sectors. Chemical Bank and Manufacturers Hanover were mentioned as competitors in aircraft and transportation equipment. Barclays and Citicorp were mentioned by some mortgage officers.

The real estate loan and mortgage business similarly has a large number of competitors. With occasional exceptions, the major subgroups are the trust companies which finance residential buildings, the insurance companies which primarily finance large commercial office buildings and shopping centres and a group of companies which are willing to finance owner occupied manufacturing facilities. This latter group includes:

- B.A. Financial Services Limited
- Caisses Populaires Desjardins
- Canada Trust
- Canadian Acceptance Corporation
- Central Trust
- Credit Foncier
- Guaranty Trust
- Permanent Commercial Corporation
- RoyNat
- United Dominion Investments Limited

and a number of local or regional brokers and trust or finance companies.

There are four other groups of institutions which have varying shares of the market in different parts of the country. These are the brokers, the credit unions, the federal government institutions and the provincial government institutions.

The brokerage firms exist in the larger centres and primarily serve to match various kinds of borrowers with private lenders or occasionally some of the commercial lenders.

The Caisses Populaire and Credit Unions have a market influence which depends primarily on the province in which they are located. They are very strong in Quebec and quite strong in some western provinces. Their relatively small size prevents them from participating in large loans, but they can become a significant factor in lending to local businesses purchasing small equipment, particularly in more remote areas which are not serviced well by the national firms.

DREE and the FBDB are occasionally mentioned as agencies which enable a firm to make a deal.

FBDB draws a mixed reaction from loan officers. Several have virtually no contact with or knowledge of FBDB. Several felt that it was serving a useful function as a "lender of last resort" or source of funds for new businesses with no track record. Others were less than enthusiastic about it. They had comments such as these:

FBDB is priced out of the market now that its rates are no longer subsidized.

It has the natural problem of its employees not wanting to refuse good business.

It wouldn't hurt if they did their job and took high risk clients.

FBDB is not required. Their cost of money is the same as ours and their administration cost is greater.

Clients come to us because they don't like the short amortization and bureaucracy of FBDB - sometimes even arrogance.

They are our competition in practice.

Several provinces have programs roughly equivalent to FBDB. These include the Saskatchewan Economic Development Corporation, Nova Scotia Industrial Estates, the B.C. Development Corporation, the Quebec Industrial Development Corporation, Quebec's Operation Solidarite Economique and the Manitoba Development Corporation. Collectively, these generate a mixed reaction similar to the reaction to FBDB. The reaction is favourable to some and unfavourable to others, but the sample of interviews is too small to identify clear patterns.

Loan officers were asked to rank the factors which were important in competing for their type of business. A rank of 1 means that the factor is most important. The results were as follows.

Factor	Average Rank	Times Mentioned
Personal contact	1.6	27
Reputation	1.6	5
Quick Service	2.0	22
Expertise	2.2	6
Flexibility	2.3	9
Interest rate	2.4	17
Advertising	3.6	7

Personal contacts with clients, quick service and low interest rates were mentioned much more frequently than other factors. This implies that there will be continual pressure in the industry to improve marketing, decrease approval times and cut costs. The importance of the three factors and their ordering also suggests a willingness of small business to trade off ease of transaction against interest rate. This is consistent with high opportunity costs of management time in the small firm.

Sources of Business

Interviewees were asked where the financial institutions get their customers. The overall proportions for the sample of 35 questionnaires which contained usable data are listed below. The results are weighted by the number of applications which they accepted.

	Source	Percentage
i)	direct solicitation	35
ii)	other	25
iii)	dealers	19
iv)	applicant	16
v)	developers	2
vi)	referrals from lenders	2
vii)	brokers	1

The "other" category frequently included repeat business from existing clients and sometimes advertising.

The striking feature of the distribution is that only about one-sixth of applications accepted were seen by the loan officers as arising directly from the initiative of the applicants. By far the largest source was direct solicitation by the supplier. Third-party sources - dealers, developers, brokers, referrals from lenders - accounted for nearly one-quarter of the total. Together these last two sources were about three-fifths of the total, and about four-fifths of the total excluding "other". This is in contrast to what is perhaps a popular stereotype of the reluctant lender. It is indicative of a much higher level of competition for financing than that stereotype would suggest.

The distribution of the purposes for which loans were required, as estimated by loan officers, is listed below. Again, the proportions were weighted by the number of loans actually made.

	Purpose	Percentage
i)	equipment purchase	54
ii)	property acquisition	19
iii)	working capital	15
iv)	expansion	6
v)	refinancing	3
vi)	business acquisition	3
vii)	other	0

Equipment purchases, property acquisition, and working-capital requirements were the purpose of about seven-eighths of the loans made. Equipment purchases by themselves were more than one-half the total. This is consistent with the importance of equipment in the fixed assets of small businesses and its shorter life expectancy than real estate and working capital (as distinct from its components).

The loan officers indicated that some four-fifths of their business, as indicated by the weighted proportion of acceptances, came from firms in their rapid growth and maturity stages.

Stage	Percentage
i) inception	12
ii) rapid growth	40
iii) maturity	42
iv) decline	6

Several of the loan officers pointed out that a high proportion of the initial inquiries are at the inception stage but that these businesses are frequently discouraged from making a formal application since they will not be able to meet the lender's criteria for making a loan. Furthermore, the proportion of rejections is generally much higher among the applications from firms at the inception stage.

These proportions also depend somewhat on the local economy. A larger proportion of the firms in a rapidly growing centre like Calgary tend to be in the inception and rapid growth stage while stable areas like Winnipeg have a higher proportion in the maturity and decline stages.

The nearly one-eighth of acceptances in the start-up stage may well reflect the importance of equipment purchases. Standardized equipment used in construction, transportation, and some service industries is amenable to financing at the inception stage of a business.

Application Processing

Application processing is a significant expense in lending to small business. While the procedures vary somewhat between firms and even between offices of the same firm, the following composite procedure incorporates the features of the main steps of most of the procedures described in the survey.

1) Initial Contact. This contact usually is made over the phone. Several of the institutions, particularly those in the equipment leasing business have marketing representatives who make regular visits to potential customers and thus make the initial contact. At this time an initial verbal screening takes place to determine whether the proposed deal is the kind in which the institution is interested. Many inquiries are rejected at this stage because of small size, unsatisfactory historical performance, excessive ratio of loan to security or being in a business, such as restaurants or liquor outlets, which the firm does not want in its portfolio. The loan also has to be of the right size. Depending on the lender, the lower limit ranged from $10,000 to $1,000,000. The upper limit ranged from $200,000 to $20 million. Some trust companies and some foreign banks have large lower limits because they are really concentrating on larger clients.

2) Formal Application. Any project which passes the initial screening is written up as a formal application. This usually requires extensive documentation ranging from a few pages for an equipment lease by a familiar good client from a known honest dealer to 60 or more pages on a complex building construction project. Typically, a balance sheet for the last 3 to 5 years, a projected cash flow statement and a description of the equipment or property being financed are the minimum required information. This may be supplemented with blueprints, marketing plans, photographs, resumes, business histories and a wide variety of other information depending on the project. Captive finance companies which finance the leasing of their parent companies' equipment may dispense with financial information about the client and rely strictly on the security provided by their equipment.

3) Data Verification. This phase is used to check the veracity of the information in the application and the honesty, competence and credit worthiness of the client. Equipment and property will be appraised internally or by an external professional, if necessary, to determine its resale value. This is particularly necessary with used equipment where prices may be inflated and lead to "110% financing". There is also some tendency for dealers to inflate the price of equipment purchased using a trade-in to enable the client to obtain a larger loan.

The credit history of the client is checked with the local credit bureau, the bank and Dun and Bradstreet where applicable. Late payments, bankruptcy and lack of any history are considered to be particularly significant negative factors. Titles to building, land or equipment are searched.

4) Decision. The decision to lend money will be made on a number of criteria. The main criteria are security, financial strength, honesty and business ability. Different lenders emphasize these in different degrees or make tradeoffs between them.

Some loan officers distinguish between "cash flow lenders" and "collateral lenders." The cash flow lenders are primarily concerned with the client's ability to generate the cash flow to repay the loan. Cash flow is particularly important in sectors where the security is difficult to dispose of or has limited resale value. The collateral lenders are more concerned with the value of the security which supports the loan. Collateral is usually emphasized by lenders who specialize in real estate or equipment which has a relatively long life. In practice, both cash flow and collateral are considered and the relative importance of each is determined by the situation and the preferences of the lending firm and its loan officer.

The concern for security means that loans for plants in remote locations, old equipment, unique equipment or buildings with no alternate use (such as restaurants) or fad businesses (such as rollerskating rinks) are considered to be bad risks. Laws which make it difficult to repossess security will also cause lenders to avoid certain businesses. Examples are a Quebec law which makes it difficult to repossess from unincorporated individuals and a Saskatchewan law which makes it difficult to repossess farm machinery.

Financial strength is judged by the past financial statements, the projected cash flows and the nature of the business. The main concern is that the future cash flows be able to cover the loan repayments. Past financial statements are used as an indicator of competence and stability. Most of the loan officers interviewed were not interested in lending to clients without a proven track record as evidenced by several years of favourable financial statements. They considered the venture capital market to be the most appropriate place for these clients to obtain funds.

Projected cash flows are evaluated critically. This usually requires a knowledge of the applicant's industry and the local market. Both applicants and their competitors may be evaluated. A borrower with a single large contract would be considered vulnerable to cancellation of the contract. A borrower with no local competitors might be liable to severe decreases in business if a competitor should start up. The location, quality of building and type of tenants might be evaluated in a rental building.

The financial subsidiaries of equipment manufacturers may use the equipment as the entire security and thus not bother to examine cash flows and financial statements.

Business ability is evaluated by examining the past track record in the business, the repayment history of other loans as evidenced by credit ratings, bankruptcy and recommendations from the borrower's banker. In addition, loan officers use a large number of individual criteria. Any evidence of dishonesty would likely terminate negotiations. Loan officers look for a good mix of talents in the principals of the business, an efficient organization and regular and complete accounting reports. They may avoid businesses where much of the income is in cash and can easily go unreported. Many of the loan officers emphasized that evidence of competence and honesty was obtained by a "gut feel" obtained during interviews or plant tours.

5) Offer. The decision to accept a deal and offer a loan is handled in a variety of ways by different lenders. Some send a letter of understanding before doing their investigation. This sets out the expected terms and conditions of the deal. The lender may request a commitment fee of about 0.5% of the loan to pay for the cost of the investigation. If the customer pays the fee, the investigation will be undertaken and a formal offer will be prepared in 1 to 4 weeks depending on the nature of the deal.

Other lenders, particularly those in the equipment leasing business, use a much speedier process. Offers can frequently be confirmed over the phone within one day since the equipment often serves as the entire security.

The timing of the offer also depends on the size of the loan. Large firms usually have different levels of signing authority with the local manager being able to complete a loan under a ceiling between $25,000 and $250,000. If the loan is larger, it usually goes to a regional manager who may have signing authority of between $100,000 and $750,000. Regional approval typically adds 1 to 4 days to the processing time. The largest deals usually require the approval of a committee or the board of directors and thus must wait for a meeting of the group which typically occurs weekly. As rapid service becomes a competitive factor, some firms are raising local approval limits or developing other techniques such as local management committees to reduce the time required for approval. Several officers report that regional approval can be obtained quickly by phone if needed.

Time taken for processing applications can be vital to the small firm for both negative and positive reasons. Its liquidity management may be weak; the money may be needed quickly to proceed with an important contract or other short-lived opportunity that has arisen.

Acceptances and Rejections

Interviewees were asked about the ratio of applications accepted to total applications. Their estimates are classified into ranges of acceptance ratios below.

Range	No. of Firms	Percentage of Firms	Cumulative Percent
0-30%	13	37	37
31-45%	7	21	58
46-60%	8	24	82
61-75%	4	12	94
76-100%	2	6	100

This table indicates that most firms have to process 2 or 3 applications for every one that results in a loan. Respondents were asked to include in the **processed** category only those inquiries which actually resulted in a formal application and investigation. Many more applicants were rejected after an initial telephone inquiry or personal contact. A high proportion of these initial rejections are from individuals wanting to start businesses.

A few of the interviewed loan officers were asked for data about the manpower required to process an accepted loan and its associated rejections. The replies were approximate and varied but a figure of one man-month per loan is typical. This figure includes loan officers, but does not include clerical support staff. The loan officers did not feel that the amount of effort varied significantly with the size of the loan. If there is a variation with size, the variation is likely in the direction of more work for small loans because of higher rejection rates and more effort in gathering and analysing data from small firms which tend to have poor bookkeeping systems and managers who need advising services. The result is that the relatively fixed cost of processing cannot be recovered on the smaller loans unless a correspondingly higher rate is charged.

When asked to describe a typical loan application which would be unacceptable, 29 loan officers mentioned a number of factors. The factors were ranked in the order in which they were mentioned and the average rank was calculated for the factors as shown below.

Factor	Average Rank	No. of Responses
Poor credit rating	1.25	8
Lack competence	1.38	13
Poor cash flow	1.50	8
Poor market for product	1.89	9
Poor collateral	2.13	8
Low equity	2.25	8
Fraud or bankruptcy	2.50	4

The preceding analysis is subject to a number of statistical criticisms. However, it does indicate that credit rating, competence and cash flow are major reasons for rejecting loan applications. A poor credit rating may be due to a previous history of poor payments or a lack of any business history such as startup situations. Both cases are symptomatic of a lack of competence which was mentioned more often than any other factor. Loan officers regularly mentioned lack of experience in their industry, lack of general business competence and poor financial or bookkeeping practices as characteristic of unsatisfactory clients. This implies a need for management education.

Terms and Conditions of Loans

For the 19 interviews which provided numerical data, the median loans ranged from \$50,000 to \$2,000,000 depending on the lender and geographic location of the branch. All but 3 of the medians were in the range of \$50,000 to \$400,000. The repayment period of the loan ranged from 1 to 25 years depending on the risk and type of security. Short periods were used for riskier loans and for equipment which was expected to have a relatively short life. Most equipment loans were for periods of 3 to 8 years. Only real estate loans would qualify for periods over 10 years.

A large number of repayment plans are available. A few lenders insist on equal monthly payments, but many are willing to tailor the repayment schedule to the needs of the business. Repayment plans include:

- Payments only during the busy season (in construction).
- Quarterly payments.
- Interest payments only, for the first year or two.
- Balloon payments at the end of the term.
- No payments in first or second years.

Most lenders require some penalty for prepayment of the loan to protect against mismatching and to recover administrative costs. A common condition found was a penalty of 3 or 4 months interest. Sometimes prepayment was precluded for the first year or two. Some leasing companies allow prepayment provided that the borrower pays the difference between the principal repaid and the disposal value of the asset. If the asset has a high disposal value, they usually credit the surplus to the borrower. A few lenders do not allow any prepayment.

A variety of fees may be charged in addition to the cost of the money borrowed. Most lenders charge for direct expenses such as lien and mortgage registry and some charge for appraisal and legal fees. A few charge standby or commitment fees and application or investigation fees. Application fees are more likely to be charged to cover the cost of investigation when the customer is suspected to be "shopping around." Commitment fees are more likely to be charged when the deal is complex and the client is not certain when the money will be needed. Lenders do not like to make an open-ended commitment to lend money at an unknown time in the future. One firm charges a 0.5% nonrefundable commitment fee at the time of the offer. Another charges a 1% fee which is refundable if the loan is taken.

The interest rate on loans is calculated in a variety of ways. Trust companies usually base it on a percentage above the current rate for their Guaranteed Investment Certificates. One firm uses a floating rate based on their average cost of money. Several relate their rates to the prime bank rate. Rates range from prime to prime +6%. Prime +1 to 2% is common for customers of average risk, but 4 of the 11 firms which provided rates will go above prime +3% to prime +4.5, 4.75, 5 and 6%. Rates increase when the risk of default increases and they decrease for large loans since the investigation cost can be spread over a larger loan. For instance, one lender charges 23.25% for loans under $25,000, 21.25% for loans between $50,000 and $100,000 and 20.75% for loans over $250,000. Almost all commerical loans are being made at floating rates. When fixed rates are available, they are generally for short terms of 1 to 3 years and require a premium of about 0.5% over the current floating rate. Lenders who used to provide fixed rates are now insisting on floating rates because of the uncertainty of the current money markets and the inability to match loans with long term deposits.

For financial subsidiaries of equipment manufacturers interest rates sometimes are reduced as a means of maintaining equipment purchase prices.

The loan-to-security ratio varies between 65 and 100%. Seventy to seventy-five percent is most common with higher percentages being reserved for the lowest risk customers. For very high ratio loans, lenders sometimes require that the last few months of payments be made in advance and kept in trust. This provides added protection against default but effectively reduces the loan ratio.

A wide variety of covenants may be required although most agreements have few or none. Personal guarantees are frequently taken in addition to liens or mortgages on property. One lender requires quarterly financial statements. Several lenders occasionally require that shareholder loans not be repaid until their loan is repaid. A few mention working capital ratios or amounts, maintenance of voting control of the company, insurance on equipment or life insurance on the principals.

The type of legal instrument depends on the firm, the type of financing and the province in which the financing is arranged. Leases, floating charges, real estate or chattel mortgages, debentures, conditional sales contracts, trust deeds and bond issues are used when appropriate.

The most difficult terms to negotiate usually relate to the amount and cost of the loan. The interest rate and the amount of loan to security ratio were mentioned most frequently. Fees and covenants are also sometimes a problem, especially covenants requiring personal guarantees of the loan. Terms that are difficult to negotiate presumably make fertile ground for the growth of "attitudinal gaps".

Government Impacts

The questionnaire provided interviewees an opportunity to comment on the effect of government activities on the financing of small businesses. Open-ended questions were asked about regulation, assistance and money supply.

Answers to the question on government regulations dealt primarily with provincial laws. Comments in several provinces dealt with the adverse effect of recent consumer protection laws. Quebec law defines all loans to unincorporated businesses that are not merchants as consumer loans which then may become very difficult to collect. The result is that lenders interviewed are avoiding any loans to unincorporated businesses. Similar effects result from Saskatchewan and Alberta laws which make collection difficult. There was some concern about Federal, Manitoba and Nova Scotia laws which give prior claims during bankruptcy to unsecured creditors, wage earners and governments. The effect again is to make lenders avoid loans to some applicants. For instance, in Manitoba, it may become impossible for a labour intensive firm to borrow money because the claims of wage earners would be greater than the value of any security offered. In British Columbia, equipment cannot be repossessed if less than 20% of a loan is outstanding. This sometimes makes it difficult to collect the last 20% of a loan.

The lack of central registries in Nova Scotia and New Brunswick makes it very expensive to search titles.

Several officers desired a change in the tax law on leasing companies to permit broader use of exemptions. Several firms limit their leasing activity to the amount of tax exempt funds available to them.

Comments on the FBDB have already been discussed. The other assistance programs mentioned were the Small Business Development Bond, the Federal Enterprise Development Board, the Export Development Corporation and the DREE Grant. There was a general feeling that the government programs were too slow and too restrictive to be of very much use. Comments such as the following were common.

> The time constraint of dealing with government programs has caused us to avoid them.
>
> All government programs, especially the Enterprise Development Board, tend to be slow to respond and usually take 2 to 6 months to complete a deal.
>
> The Export Development Corporation benefits the lender, but the borrower sees long processing time and high cost.
>
> The Ontario Development Corporation is very slow.
>
> The Saskatchewan Economic Development Corporation tends to have many restrictive covenants and wants to run the organization.
>
> If you have to go to a government program, you are right down to the bottom of the quality list.

One program which generated exceptionally few complaints was the Small Business Development Bond. Companies using the SBDB are apparently very happy with them and consider them helpful and easy to use. One lender referred to it as: "an impressive program since it has very little red tape." Firms not using them are concerned that some business had been diverted to those who do use them, but had no plans to go into them. Many of those who were not using the SBDB either were not aware of the features of the program or felt that the program would be too shortlived to justify the effort of learning about it. One officer said that: "The Federal Enterprise Development Program lets us do a lot of deals we could not have done otherwise." Another said that "the Federal Enterprise Development Program is slow to respond with guarantees and sets onerous conditions."

DREE grants are generally considered to be useful in the areas where they apply although they may work against institutions which specialize in leasing since they require that equipment be purchased.

There was a consensus that tight money conditions decrease the volume of business by making some projects uneconomical. However, only two lenders claimed that they had difficulty obtaining money to lend during such periods. One lender said their margins decrease during tight money conditions because they are unable to pass on all of the increase. Another noted that receivables are harder to collect then. Some lenders are suffering from mismatched funds as interest rates fluctuate and may find themselves sourcing longterm fixed rate loans with higher rate current borrowing.

Suggested Improvements

When asked what suggestions they had for improving private small business financing, there were two suggestions that were each made five times. One was that economic changes are needed to reduce interest rates and thus stimulate business. The other was that the government should provide some sort of guarantee on loans to first time borrowers or high risk borrowers. Such a program is sometimes suggested as an alternative to the FBDB.

There was some concern that the number of regulations increases investigation and administration costs. The effect of provincial consumer laws has been discussed previously.

The following were mentioned once or twice each:

- Relax the tax deductability of leasing.
- Provide better business education.
- Maintain a comprehensive directory of financial sources.
- Encourage specialization in financial institutions.
- Prevent competition from government services.

When asked what suggestions they would make to small businesses, lenders made a wide variety of comments. The common thread among the comments was that small businesses need more professional business competence. Typical problems are that the applicant has no clear business plan, has a poor bookkeeping system and does not understand the financial structure of his business or the financial implications of his proposed actions. Many borrowers are apparently unable to provide proper financial statements for evaluation and do not understand how to work with their accountant, banker and lender to improve their situation. One lender estimated that less than 25% of his applicants had any managers with formal training in business or accounting.

This situation implies that there is a large need for education of small business managers in the basic principles of management. This could be done by a variety of methods ranging from correspondence courses and seminars to formal programs in high schools, community colleges and universities. There may be a need for more government support to develop materials in this area or subsidize the delivery of such programs.

II. Survey of Financing Files

This survey of loan files was conducted to provide concrete information about the borrowers who are being financed and about the terms and conditions of the financing being provided.

A sample of actual loan files was obtained from seven cooperating lenders. Data were gathered on a coding form illustrated in appendix D. Information was obtained on the form and purpose of the loans, the costs and repayment schedule, the security, the financial statements of the firm and the assessment of the firm's management.

The coding was performed by members of the study team who examined the files at regional or head offices of the participating firms.

The sample is not statistically representative because regional and small specialized lenders are not represented. The cost of contacting a large number of smaller lenders and sending coders to examine their files would be prohibitive. Two lenders who were contacted were unwilling to participate because of corporate policies about confidentiality. Despite these limitations, the data are likely to be typical of the industry to the extent that all of the sampled lenders are national firms competing with most of the lenders who are not represented.

Fourteen of the 435 loans in the sample were not approved by the lender and have been deleted from the sample since they might introduce some bias into the results. There are not enough unapproved loans to permit a meaningful analysis of the differences between approved and unapproved loans. It was not possible to obtain a larger sample of unapproved loans since most lenders keep those filed in their local offices or destroy them.

The Borrowers

The participating firms were all national lenders with 2 trust companies, 2 leasing firms and 3 general lenders represented. One of the lenders is the financial arm of an equipment manufacturer.

Sample Characteristics

The following table lists the number of files obtained from each of the participating lenders. The lenders are not identified because several requested that their names remain confidential.

Lender	Number	Percent	Type
A	160	38	General
B	113	27	General
C	51	12	General
D	41	10	Trust
E	25	6	Trust
F	21	5	Lease
G	10	2	Lease
All	**421**	**100**	

Loan applications in the period from January 1980 to July 1981 were examined. All loans in the sample period approved by 3 of the lenders are included in the study. Only a partial sample was taken from the other lenders. The loans are classified below by the province of the borrower and compared with the percent of industrial value added in each province.

Province	Number	Percent	% Industrial Value Added
British Columbia	46	11	10
Alberta	60	14	15
Saskatchewan	22	5	5
Manitoba	10	3	4
Ontario	131	31	39
Quebec	100	24	23
New Brunswick	21	5	2
Nova Scotia	31	7	2
	421	**100**	**100**

The 421 approved loans had the following characteristics.

Characteristic	Number	Percent
Subsidiary	156	37
Repeat customer	195	46
Accepted by borrower	357	85

The 15% of borrowers who had not accepted the loan includes 6% of the 421 who had not yet made a decision and could still accept the loan. The acceptance ratio is likely biased by the source of the data. Loans which were turned down by the borrower are frequently purged from the lenders' files and are, therefore, unavailable for examination. Furthermore, many deals are rejected by the borrower, after much analysis at the regional office, but before a formal file is prepared for head office.

SIC codes were provided by 261 of the borrowers in the sample. Fifty-five different 2-digit industry codes appeared in the sample. The results are summarized at the 1-digit level in the table below.

Industry	1-Digit Code	Frequency	%
Agriculture, mining	0	6	2
Food and chemical	1	51	19
Wood, paper, metal	2	35	13
Manufacturing	3	84	32
Construction, utiity	4	33	13
Wholesale trade	5	25	10
Retail trade	6	7	3
Real estate and service	7	17	7
Education and accommodation	8	3	1
		261	**100**

The following financial ratios were calculated for each of the firms for which data were available.

working capital ratio	=	current assets/current liabilities
leverage	=	liabilities/assets
debt/equity ratio	=	(current liabilities + long term debt + leases)/net worth
return on assets	=	(net income after taxes + debt service)/total assets
return on equity	=	net income after taxes/net worth

These ratios were classified by 1-digit industry codes and are summarized in the table below. Industry 0 includes those firms for which no industry code was available. The mean of the ratio is given for each industry along with the sample size below it in brackets.

Industry	Working Capital	Leverage	Debt Equity	Return On Assets	Return On Equity
0	1.48	.596	5.55	.169	.536
	(134)	(166)	(132)	(101)	(123)
1	1.37	.605	4.22	.179	.759
	(45)	(51)	(45)	(32)	(40)
2	1.63	.453	.53	.138	.248
	(27)	(35)	(26)	(15)	(24)
3	1.16	.466	3.17	.133	.099
	(57)	(84)	(57)	(42)	(51)
4	1.29	.635	10.76	.213	.614
	(29)	(33)	(29)	(20)	(24)
5	1.50	.655	4.27	.239	.154
	(22)	(25)	(22)	(13)	(22)
6	1.64	.696	6.59	.073	.365
	(6)	(7)	(6)	(3)	(6)
7	0.76	.657	16.21	.141	1.690
	(15)	(17)	(15)	(9)	(15)
8	0.79	.989	3.26	-.043	.920
	(3)	(3)	(3)	(3)	(3)
All	1.37	.573	4.85	.165	.506
	(338)	(421)	(335)	(238)	(308)

The debt/equity ratios and the rates of return on equity are very high because many small businesses do not make a realistic statement of the equity which they have provided. The balance of the equity is provided in the form of the owner's personal guarantee or by a mortgage on personal property, but is not shown on the books of the firm. For this reason, the reader should not attempt to interpret these ratios in the usual manner.

In addition to the above data, the average of the total assets, the amount of the loan, and the loan to security ratio were tabulated for each 1-digit industry along with the sample size in brackets after each number.

Industry	Assets($1,000)		Loan($1,000)		Security Ratio	
0	4961	(134)	540	(166)	.982	(166)
1	2910	(45)	357	(51)	.510	(51)
2	3370	(26)	366	(35)	.697	(35)
3	1194	(56)	290	(84)	.903	(84)
4	1172	(30)	200	(33)	.481	(33)
5	1513	(23)	94	(25)	.489	(25)
6	6663	(3)	363	(7)	.221	(7)
7	872	(14)	140	(17)	1.187	(17)
8	1695	(3)	89	(3)	.284	(3)
All	3197	(337)	378	(421)	.807	(421)

PURPOSE AND FORM

Data were gathered on the amount, purpose, and form of the loans. The total amount of all loans was $172 million. The following table shows the form of the loans by the percentage of loans involving each form, the total amount of each form, and the percentage of total funds lent in each form.

Form	**% of Loans**	**$ Million**	**% of $**
Debenture	27	62.6	36.4
Mortgage	17	59.5	34.6
SBDB Debenture	15	13.6	7.9
Commercial Pledge	4	10.8	6.3
Lease	20	6.5	3.8
Chattel Mortgage	7	6.1	3.5
Conditional Sale	17	4.8	2.8
Other	2	8.0	4.7
	109	**172.0**	**100.0**

The percentage of loans adds to more than 100 because some of the loans were secured by more than one form of security. The table is in descending order of total amount of each kind of loan. A relatively large proportion of loans are secured by leases, chattel mortgages and conditional sales contracts, but the value of these loans is relatively small. The larger loans tend to be secured by debentures, mortgages, and commercial pledges.

The next table classifies the loans by their purpose showing the percentage of loans involved, the total dollars and the percentage of total dollars.

Purpose	**% of Loans**	**$ Million**	**% of $**
Purchase equipment	50	73.9	30.8
Refinance	19	56.2	23.4
Purchase real estate	26	54.4	22.7
Working capital	14	13.6	5.7
Equipment lease	19	6.3	2.6
Other	21	35.4	14.8
	149	**239.8**	**100.0**

The percentage of loans exceeds 100 because 30% of the loans are for more than 1 purpose. Some had up to 5 different purposes. The total dollars involved are not the same as the dollars shown for the various forms of security because the purposes usually include money from other outstanding loans. The refinancing category contains both the refinancing of loans by other lenders and by the current lender. The large percentage of refinancing would suggest a large amount of competition for the borrowers' business.

The following table breaks down the number of loans (upper figure) and the average amount of the total loan in thousands of dollars (lower figure) by the purpose and form of the loan. When a loan was for multiple purposes or forms, the first purpose or form on the questionnaire which was applicable was used.

	Equipment	Refinance	Real Estate	Working Capital	Equip. Lease	Other
Debenture	36 752	25 732	23 350	5 170		10 795
Mortgage	3 902	33 1051	19 953	7 567		9 923
SBDB Debenture	12 213	12 214	10 170			
Commercial Pledge	14 85					
Lease	5 29	1 35			78 55	2 42
Chattel Mortgage	27 198	1 70	1 150			1 15
Conditional Sale	66 53				1 60	
Other	3 360		1 30			

It is clear from the table that equipment is financed in a wide variety of ways and that mortgage and debentures are frequently involved in refinancing and purchases of equipment and real estate. A few single loans, such as purchase of real estate by chattel mortgage, are obviously inappropriate and result from the inappropriate classification of loans with multiple forms and purposes.

TERMS AND CONDITIONS

Data were gathered on the interest rate charged on loans and on the other terms and conditions which were applied to the loans. Loans are usually approved at an interest rate which is an increment over some basis value. The basis value may be the bank prime rate or some internal rate such as the rate on guaranteed investment certificates or a weighted average of the cost of funds. The rate may be a fixed or a floating rate.

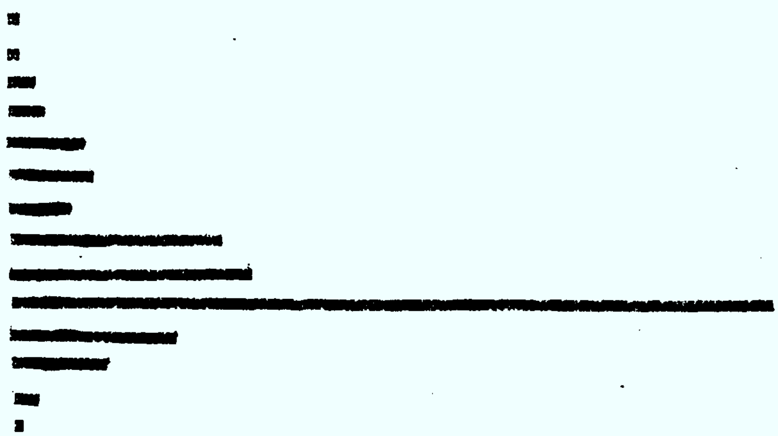
To provide comparability, all of these rates converted to an effective yield which is the sum of the basis and the increment. A margin was computed by subtracting the Royal Bank prime rate on the date of approval from this yield as follows:

MARGIN = (BASIS + INCREMENT) - ROYAL BANK PRIME

The average margin was 1.17% ranging between -7 and +6%. A number of negative margins were associated with one of the lenders which was the financial arm of an equipment manufacturer and was apparently charging less than prime as an inducement to purchase their parent firm's equipment.

The following histogram shows the distribution of margins when rounded to the nearest integer value.

Frequency	**Margin**
1	-7
1	-6
6	-5
7	-4
15	-3
16	-2
12	-1
43	0
49	1
155	2
34	3
20	4
5	5
1	6
415	



Most of the loans are at margins in the range between 0 and 3%. However, 6% of them were at higher margins. Some of the lower margins may have been below prime because of informal commitments or extensions of previous loans during a period of rising interest rates. Fifteen percent of the loans were at fixed rates.

The loan contracts were checked for fees, restrictive covenants and other conditions. The proportion of loans with each type of fee, covenant, and condition is tabulated below.

	%
Fees	
Nonrefundable negotiating fee	42
Refundable negotiating fee	1
Standby fee for undisbursed funds	39
Cancellation fee	27
Loan prepayment fee	42
Other fee	3
Equity participation feature	2
Covenants	
Working capital	53
Debt/equity ratio	21
Subordinate debt	8
Voting control	44
Dividends or bonuses	1
Line of credit	7
Provide annual audited statements	39
Provide annual unaudited statements	11
Provide interim unaudited statements	42
Restrict shareholder loan repayment	18
Other	
Floating charge	36
Lease purchase option	17
Lease purchase obligation	1
Blended payments	45

Three of the lenders apparently made a standard practice of applying several of the covenants and fees to most of their contracts. On the other hand, four of them seldom applied covenants or fees to the loans.

There was **no** significant difference between the proportion of fixed rate loans in 1980 and in 1981. Nor were there significant differences in the proportion of fixed rate loans for different purposes. However, there were significant differences in the proportion of fixed rate loans granted by different lenders or used with different financial instruments. One of the lenders granted 79% of the fixed rate loans. Eighty-three percent of the fixed rate loans were secured by mortgages, debentures, or SBDB bonds.

The loans have been classified by amount to show their size distribution in the following table.

Amount ($1,000)	Frequency	% of Loans	% of $
0 - 25	84	20	1
26 - 50	58	14	1
51 - 100	52	13	3
101 - 200	62	15	6
201 - 500	76	18	18
501 - 1000	47	11	19
1001 - 7000	42	9	52
	421	100	100

As expected, the largest number are in the smallest sizes with nearly half of them for amounts under $100,000. However, the larger loan categories represent by far the largest dollar volumes.

The amounts of the loans have also been cross tabulated against margins over prime rounded to the nearest whole number. The table, shown below, has a chi squared statistic which indicates that the rows and columns are not independent at the 99.9% confidence level. Inspection reveals that the number of margins around 1% increases with loan size relative to margins of 2%. The larger and smaller margins show no observable pattern.

Loan	Margin					
($1,000)	0	0	1	2	3	3
0 - 25	4	5	5	58	5	7
26 - 50	5	6	8	29	5	4
51 - 100	15	7	5	18	4	2
101 - 200	10	7	19	16	6	3
201 - 500	11	3	28	21	7	5
501 - 1000	5	9	18	6	4	5
1001 - 7000	6	4	15	6	2	0

The term and amortization period of the loans was examined. Three and five years were very common terms. However, 38 different maturities were encountered in the sample. The distribution is shown in the following table.

Term (Months)	Frequency	%
0 - 12	6	2
13 - 24	19	5
25 - 36	58	15
37 - 48	44	11
49 - 60	212	54
61 - 72	35	9
73 - 84	7	2
85 - 120	8	2
	389	**100**

Amortization periods of 5, 10, 15, and 20 years were very common, but 42 different periods were encountered. The distribution is tabulated below.

Period (Months)	Frequency	%
1 - 36	18	8
37 - 60	40	18
61 - 120	48	21
121 - 144	16	7
145 - 180	54	24
181 - 240	40	18
241 - 300	10	4
336	1	0
	227	**100**

The number of guarantors on each loan is tabulated below.

Guarantors	Frequency	%
0	180	43
1	98	23
2	83	20
3	29	7
4	15	3
5	5	1
6	3	1
7	3	1
8,9,12,17,40	1 each	1
	421	**100**

Forty-three percent of the loans required no guarantor and another 43% required 1 or 2 guarantors.

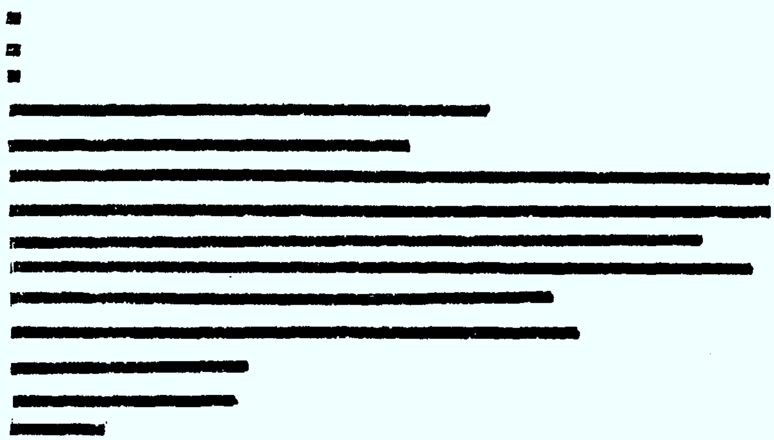
MANAGEMENT ASSESSMENT

Whenever qualitative assessments of borrower management were available, they were recorded and classified on a 3 point scale of weakness, neutrality, and strength. In the analysis, -1, 0, and 1 points were assigned for weakness, neutrality, and strength respectively. An average rating was computed for each factor assessed and is tabulated below in order of rating.

Factor	Rating	Responses
Personnel	.92	306
Experience with lender	.89	176
Strategic plans	.76	216
Industry outlook	.74	213
Past trend	.67	313
Cash flow	.60	293
Term of lease	.60	30
Performance of subsidiaries	.60	64
Financial condition	.58	270
Working capital	.46	261
Debt/equity ratio	.45	254
Equipment resale value	.35	135
Security base	.35	275
Liquidation protection	.34	44

The ratings were aggregated into a score for each borrower using -1,0, and 1 points for weakness, neutrality, and strength respectively. Such an aggregate score is difficult to interpret, since an equal weight is given to each factor even though lenders may apply different weights to each factor and some lenders do not consider some factors at all. However, the aggregate score is a rough indicator of the management strength of the borrower. The frequency of each possible score is shown in the histogram below.

Frequency	Score
1	-3
1	-2
1	-1
36	0
30	1
57	2
57	3
52	4
56	5
41	6
43	7
18	8
17	9
7	10



CONCLUSIONS

1. Financial markets are very competitive. Loan officers perceive that they have many competitors and their offers are frequently rejected by borrowers who are shopping for better terms. Many lenders use marketing representations to locate new business. Loan files indicate that 17% of loans involve refinancing. Many of these are likely refinancing loans by competitors. Banks are seen as major competitors by most NBFIs.

2. Lenders specialize in specific submarkets. The need for specialized knowledge about security and industry factors forces lenders to specialize by industry or by type of security. Loan files indicate that they also specialize in specific forms of security such as mortgages.

3. Equipment loans are usually arranged rapidly and cheaply by using simple formulas to determine how much money can be loaned on the equipment as security. Project loans typically involve larger fixed negotiation costs since extensive documentation must usually be assembled and a significant amount of time must be spent evaluating the documentation and the management of the borrowing firm. After all this effort, the borrower may still reject an offer of financing.

4. There is a large variety of terms and conditions applied to loan contracts. Lenders will frequently tailor repayment terms to the borrowers' needs. They also use a wide variety of legal instruments and types of security. About 15% of the loans are at fixed rates and 6% are at interest rates greater than Royal Bank prime +3%. Nearly 47% of the loans were for amounts under $100,000. Eighty-five percent of the loans were for terms of 5 years or less. Over 55% of the loans required 1 or more guarantors. Virtually, all small business loans require security in the form of collateral or guarantors.

5. Government financial programs are perceived to be too slow and too restrictive to be of much use to borrowers. The Small Business Development Bond is one exception to this statement.

6. The main causes for rejecting loans are poor business plans, poor bookkeeping practices, and lack of professional business competence on the part of the borrowers. This is supported by data from loan files which show that a large majority of approved loans are to firms rated as having good personnel and good business plans. Since lenders consider these factors to be very important, they reject applications from borrowers without these characteristics.

Chapter 7

CREDIT UNIONS AND SMALL BUSINESS FINANCING: AN INTERVIEW SURVEY

by
Len Fertuck

Purpose of Study

This study was conducted to determine the degree to which Credit Unions are currently involved in small business lending and the prospects for further involvement in business lending. The study is sponsored by Credit Unions and Caisses Populaires outside Quebec so the interviews were conducted in provinces other than Quebec. The term Credit Union in this chapter will be taken to mean a Credit Union or a Caisse Populaire as appropriate.

Organizational Structure

The Credit Union movement is a democratic, multilevel, decentralized organization. Its organization is very different from that of a typical corporation and this has some important effects on the things which the movement can and cannot accomplish. Individual credit unions are controlled by their members who each have one vote in electing a board of directors to set policies within the restrictions set by the Credit Union Act of each province. The individual Credit Unions, in turn, govern a Credit Union Central in their province with each Credit Union having one vote in electing directors. Provincial centrals in each province except Quebec and Newfoundland along with several large cooperative organizations, have formed the Canadian Cooperative Credit Society (CCCS).[1] The main purpose of CCCS and the provincial centrals is to provide liquidity by lending to and taking deposits from the member organizations. The control structure in the movement resembles an inverted pyramid.

Local Credit Union
Provincial Centrals
CCCS

1 Two centrals in Ontario are shareholders of CCCS. La Federation des Caisses Populaires Acadiennes Limitee is not a member of CCCS, but participated in the survey.

With this structure, there is no single organization with the authority to make decisions on behalf of the entire movement. Ultimately, the individual Credit Unions are able to decide on the kinds of services which they will provide and what prices they will charge for them. The only restrictions are those imposed by the provincial Credit Union Acts and the movement's philosophical belief that all members should be treated equally.

A major provision of the various provincial Credit Union Acts is that a reserve for bad debts must be maintained. The Acts provide for some form of supervision of these reserves, usually by a government department. In several provinces, this function is contracted out to the Credit Union Central which then finds itself elected by the Credit Unions, but with authority to enforce various reserve requirements and specify operating policies. In addition, the centrals provide a variety of central services such as cheque clearing, advertising, computing, and research. In these respects, the central is like an elected government, elected by individuals to provide common services and enforce certain rules for the benefit of the community.

This structure requires that there be a broad agreement on policies before significant changes can be made by CCCS or the centrals. Numerous meetings and conferences are held within the movement to exchange views and information as part of this consensus-building effort.

While the Credit Unions are held together by a common philosophy of cooperation, they, nevertheless, have a wide variety of structures, problems, and needs. The major differences can be described in terms of size, membership and competition. Sizes range from many Credit Unions with less than a million dollars in assets to Van City Credit Union in Vancouver with over a billion dollars in assets.

The membership is determined by each Credit Union's bond of association which describes the geographic area in which the Credit Union may trade and who may become a member. Credit Unions may be broadly grouped into open bond and closed bond types. The open bond Credit Unions can serve anyone in their trading area which is usually a city. The closed bond Credit Unions are limited to serving members who belong to a particular firm, occupation, organization, or religious group. Large open bond Credit Unions are frequently found in Western Canada. Closed bond Credit Unions are much more common in Ontario and the Maritime provinces. The Maritime provinces generally have much smaller Credit Unions. Only 1 of the 100 largest Credit Unions is in the Maritimes and 72 of the largest are in the 4 Western provinces.

The competitive position of Credit Unions varies by province and within provinces. The Credit Unions usually have a larger share of the market in smaller centres where banks are not as well represented. They also have a large share of the market in Western Canada where most centres have a community bond Credit Union with several branches. Frequently, these branches are located in co-op operated shopping centres such as a grocery store, a department store, a service station, or an insurance office. In Ontario, the Credit Unions with corporate bonds may have a large share of the accounts of the employees of their company.

The range of services provided will vary with each Credit Union. The smallest ones may provide only savings and loan services. The larger ones often provide most of the services of a bank including chequing accounts, drive-in tellers, automatic teller machines, bill paying services, and commercial loans and lines of credit.

The assets of Credit Unions are distributed among the provinces as shown below using 1980 figures.

Province	**Assets ($ million)**	**% of Assets**	**Members As % of Labour Force**
British Columbia	5,100	16.5	76.1
Alberta	2,080	6.8	49.0
Saskatchewan	2,600	8.4	130.2
Manitoba	1,286	4.2	67.0
Ontario	5,044	16.3	42.7
Quebec	14,100	45.7	172.7
New Brunswick	360	1.2	76.5
Nova Scotia	207	.7	46.0
Prince Edward Island	37	.1	50.0
Newfoundland	32	.1	6.7
Total	**30,842**	**100.0**	**85.0**

The highest proportion of assets and highest ratio of members to labour force are concentrated in Quebec. Saskatchewan has the next highest membership penetration which is over twice as high as that of New Brunswick and British Columbia, the next highest provinces. By dollar volume, Quebec, British Columbia, and Ontario have the largest systems.

Sample Selection

This study was conducted by interviewing people involved in small business lending at various levels in the Credit Union movement in all provinces except Quebec, Prince Edward Island and Newfoundland. Interviews were conducted with representatives of CCCS; the provincial

Credit Union Centrals in New Brunswick, Nova Scotia, Ontario, Manitoba, Saskatchewan, Alberta, and British Columbia and the commerical loan officers in 17 Credit Unions in the above provinces. An attempt was made to interview the Chief Executive Officer at each of the provincial centrals and ask the questions shown in Appendix D (i). The supervisors of commercial lending at each central were asked the questions in Appendix D (ii).

The supervisors of commercial lending identified Credit Unions in their provinces which were doing a significant amount of commerical lending and 17 commercial loan officers in these Credit Unions were interviewed to answer the questionnaire shown in Appendix D (iii). This questionnaire was designed to be comparable to the questionnaire used for loan officers in Chapter 6. An interview with the loan officer from a Credit Union used in the loan officer survey has also been included in this study.

The Credit Unions, in the sample, were generally the larger ones since small ones do not have the assets or expertise to handle commercial loans. All but 2 of them had assets over $30 million. Only 1 of them was in the Martimes, but this is representative since only 1 of the 100 largest Credit Unions is in the Maritimes. Seventy-two of the 100 largest are in the 4 Western provinces and 72 percent of the sample came from the 4 Western provinces.

Market Served

The commercial lending services provided by Credit Unions are limited by the provincial Credit Union Acts, regulations under the Acts, restrictions within the bond of association for each Credit Union, restrictions within the local by-laws, and restrictions imposed by Credit Union managers or loan managers.

The provincial Credit Union Acts generally do not place very severe restrictions on commercial lending. Nova Scotia places a limit of 25% of capital in commercial loans. Ontario places a limit of 7% which can be raised to 15% with government approval. The other provinces surveyed had no limit on proportion of assets in commercial loans. Several provinces set an upper bound on the maximum proportion of assets in a single corporate loan as shown below:

Province	Limit
British Columbia	5% (by guideline)
Alberta	-
Saskatchewan	8
Manitoba	10
Ontario	1 (5% to individuals)
New Brunswick	5
Nova Scotia	10

These are usually not considered to be a limitation. Most Credit Unions impose a more stringent limit on themselves to mimimize their risks.

British Columbia requires that operating loans be reviewed annually. Otherwise, there are no legal restrictions on the term of commercial loans. British Columbia sets out specific requirements on the amount of security which is required for various kinds of loans. All other provinces require that loans be secured, but usually have a very loose definition of security so personal guarantees can sometimes be used as security. Generally, loan officers did not see this requirement as a problem since they usually took more secruity than was required.

The Acts do not impose membership requirements except that the Saskatchewan central is restricted to dealing with co-ops, governments, or non-profit agencies. Even this can be circumvented by incorporating a subsidiary without these restrictions. These are no membership restrictions on the individual Credit Unions except those inherent in their bond of association. These can sometimes prevent ethnic or parish Credit Unions from expanding into commercial loans outside their existing membership.

The larger community Credit Unions sometimes find themselves competing for the business of borrowers who could qualify as members of more than one Credit Union. This occurs particularly in large centres such as Vancouver which have more than one community Credit Union. These problems are generally resolved by some "gentlemen's agreement" between the loan ~~officers.~~

legislation

Each of the Acts provides for some form of auditing and supervision of Credit Unions by a Stabilization Fund or other body. This body ensures that ~~members will not lose~~ their deposits in case of a bankruptcy and generally has the power to take over the management of an ailing Credit Union. These bodies usually have a system of graduated approval limits by which the provincial board must approve commercial loans larger than some designated size. The designated size generally increases with the assets of the Credit Union and with the competence of the management as evidenced by loss experience. Some of the larger Credit Unions with extensive experience have been granted complete exemption from the approval process. On the other hand, Ontario, which has had very limited experience in commercial lending by Credit Unions, is developing more stringent approval requirements in response to its loss experiences.

not traditional.

It is not common for Credit Unions to explicitly restrict commercial lending in their local by-laws. However, both loan managers and credit committees frequently avoid commercial loans for a variety of reasons ranging from lack of experience in the field to lack of funds. Credit Unions are generally operated for the benefit of their members. During times of scarce funds, a manager would prefer to make 20 personal loans of $10,000 rather than one commercial loan of $200,000 because 20 times as many voting members would be served. They see personal loans as their main function with commercial lending being an opportunity for expansion and diversification and improved matching of liabilities and assets.

Within each Credit Union, all loans above a limit of a few thousand dollars must be approved by a credit committee. Large loans and loans to directors must be approved by the Board of Directors. The credit committee and board usually set restrictions on the maximum size of individual loans and the types of loans they will make along with the terms and conditions which will be required. Some of the larger Credit Unions have detailed policy manuals which cover almost every type of loan which they could make. The restrictions they set for themselves are usually much more stringent than those required by the Act or regulations.

It is quite common for a particular Credit Union to specialize in certain types of commercial loans such as property mortgages, interim construction financing, or lines of credit, although some do lend to a broad spectrum of clients. The choice tends to be governed by local needs, opportunities, and competence. The rural Credit Unions are more likely to lend to a broad spectrum of borrowers because the loans are needed in a community with relatively few alternatives. Large urban Credit Unions tend to specialize in a particular type of loan because they do not have the skills to compete in all of the highly competitive markets in a large city. The selected specialty typically depends on the skill and interests of the management and the available opportunities in the community.

Data in the demand study of Chapter 4 were examined for any mention of Credit Unions. Of the 292 usable replies to the questionnaire, two firms said that they would approach a Credit Union for funds before going to banks, shareholders, trust companies, or other sources. Eighteen would consider a Credit Union for long term funds and 28 would consider a Credit Union for short term funds along with other insitutions. The responses were distributed relatively evenly through the ten sampled cities except that none was in the Maritimes and a relatively large number were in Quebec City.

The firms which would consider Credit Unions for financing tended to be younger than average, smaller than average, and less likely to have a full time financial manager.

Advantages and Disadvantages

In 29 of the interviews, Credit Union loan officers and personnel at the centrals were asked what they thought were the major advantages and disadvantages of going into commercial lending. The frequency of responses is summarized in the following table.

Advantages	Frequency
Floating rate for maturity matching	13
Opportunity to lend surplus funds	13
Service demanded by members	13
Image and benefit to community	11
Higher yield than current loans	10
Spinoff deposits	10
Diversifies portfolio	5
Cheaper to administer	5

Disadvantages	Frequency
Need expensive expertise	25
Risk of large individual losses	14
Extra administration needed	12
Higher risk of default	9
Committment to increased future loans	3

The advantages can be grouped broadly into financial benefits and service benefits. Financially, the opportunity to put out money at a floating rate appeals to Credit Unions who usually aggregate short term savings and current account deposits and lend fixed rate home mortgages and personal loans. Many have suffered severely from problems of maturity matching and see commercial loans at floating rates as a way to reduce that problem in the future. They also see commercial loans as providing higher margins over their cost of funds as well as providing a way of diversifying their portfolio of loans so that they will be less sensitive to fluctuations in particular markets such as housing.

Some Credit Unions are concerned that their traditional loan markets in personal loans and house mortgages may be shrinking. They see much of the traditional personal loan market being taken over in the future by credit cards operated by large organizations. Likewise, they fear that the demand for mortgages will decrease as the population ages and a larger proportion of homes are fully paid for. Commerical loans provide an opportunity to place surplus funds. A number of Credit Unions have been having problems in generating enough personal loans to place all of their available funds and are looking at the commercial alternatives.

Commercial lending is seen as a benefit to members and to the community because it serves members who wish to start or expand a business and recycles capital for business expansion in the community which might not otherwise occur.

A number of other spinoffs occur. The Credit Union gets an image of community involvement and a certain amount of free publicity when its name is seen on supply and payroll cheques. Many Credit Unions in commercial lending insist that deposit accounts, lines of credit, payroll deposits, and other financial services also be obtained from them. Some believe that by this means they are usually able to generate enough deposits to fund their commercial lending.

There are some costs associated with these benefits. The major one, mentioned by nearly all respondents, is the need for new, specialized, and expensive expertise to analyze and administer such loans. They regularly emphasized that commercial lending is very different from consumer lending and requires a good understanding of the borrower's business, of the value of security taken, and of techniques for monitoring loans. Those already in the field advised potential entrants to be extremely cautious, since it takes a significant amount of time to build a portfolio of commercial loans and that the borrowers who first come to a new lender are usually of less than prime quality, often having already been turned down by another lender.

Most of the Credit Unions now making commercial loans appear to have started by making personal loans to their members for business purposes and have gradually grown with the member. Some did not want to go into the field, but saw it as a necessary service demanded by members. The successful loans often lead to larger loans the following year which may put a strain on the Credit Unions available funds. They may eventually become so large and need so many other services, such as foreign exchange, that they have to be turned over to a bank. Thus, the Credit Unions have historically played an important role in developing entrepreneurs through the difficult initial stages of a business. They have some competitive advantage in this respect because they usually have longtime members of the community as loan officers and committee members. These people sometimes lack skill in technical analysis of loans, but they are much more capable of character evaluation than the transient managers of banks, since they have had more personal experience with the client and a better understanding of the local competitive environment which he will face.

There was general agreement that commercial loans are riskier in the sense that if there is a default it would likely be large and would have a noticeable impact on the financial position of the lender. Some Credit Unions have tried to ameliorate this problem by syndicating large loans with other Credit Unions to spread the risk. Some provincial centrals are developing facilities for syndication, but they are currently at a very early stage. There is little agreement among the Credit Unions about whether this is desirable. Some feel that such facilities will be necessary to keep the larger loans within the movement. Others, particularly the larger ones, are concerned that the centrals may begin to compete with them for such loans, that the centrals may not have the necessary expertise themselves, or that the centrals will add a layer of bureaucracy to the process. The smaller

Credit Unions do not expect to benefit from syndication or commercial lending generally and see central involvement as a waste of resources that could have been used to deal with their special problems. As a result, movement toward central syndication of large loans is likely to be quite slow. Private syndications among cooperating Credit Unions are already occurring on an informal basis on loans that typically amount to a few million dollars each.

There is some disagreement about the inherent risk of commercial loans. Some loan officers believe that there is inherently a higher probability of default among commercial loans. Others believe that this is only true when the loan officers are not expert enough to screen out the bad loans. In one province, 75% of loans written off were commercial loans.

The supervisors of commercial lending at the centrals did not volunteer details about loss experiences in commercial lending, but it was apparent that a number of Credit Unions have had significant losses and have been placed under supervision to ensure that they do not continue to make loans which are uncollectable. The supervisors are now very cautious about Credit Unions which are just beginning to make commercial loans and pay careful attention to the experience level of the loan managers.

Similarly, there is disagreement about the relative cost of administering commercial loans and personal loans. Some claim that commercial loans take relatively less administration because of their larger size. Others argue that a great deal more analysis is needed before making a loan and much more follow-up is needed to make sure that the business is solvent and that assets such as inventory and receivables really exists. An institution which also handles the borrower's current account has some advantage in getting a current picture of the business. It is possible that those managers who believe that less administration is required are not doing enough monitoring.

It is quite clear from interviews at all levels that commercial lending is suitable only for the larger Credit Unions. Even if a Credit Union were willing to lend 5% of its assets to a single customer - usually considered an imprudently large proportion - it would need assets of at least $1 million to be able to make a $50,000 loan. Furthermore, a Credit Union of such a size would not be able to afford the specialized expertise needed to analyze and monitor commercial loans. The minimum practical size is likely around $20 to $30 million in assets which restricts commercial lending to about 100 Credit Unions in the provinces outside Quebec. A number of these large organizations are not likely to be interested because their bond of association limits them to members who are salaried employees and are unlikely to want commercial loans.

The actual amount of commercial lending by Credit Unions is difficult to determine since the provincial centrals do not gather data about commercial loans. Sixteen of the Credit Unions interviewed provided estimates of their commercial loans as a percent of assets. The figures ranged from 1 to 30 percent with an average of 16%. There was a consensus that commercial loans should not exceed 20 to 25 percent of the assets of a Credit Union for portfolio balancing reasons.

The estimate of 16% is probably somewhat high because of sample selection biases. Interviews were conducted primarily with Credit Unions who were making commercial loans. Most of the other large open bond Credit Unions in Western Canada are also doing some commercial lending so this figure may be an appropriate estimate for them also. However, there are a number of large closed bond employee Credit Unions in Ontario which are unlikely to be making commercial loans to their members. Considering these Credit Unions who are not making such loans and the number of smaller ones who are, an estimate of 12% of the assets of the 100 largest Credit Unions is probably a fair estimate of the amount of commercial lending by Credit Unions outside Quebec. This figure would be about $1 billion which is roughly half the size of the FBDB portfolio.

Types of Business Loans

The types of loans made vary with the individual Credit Union. Virtually all types of loans except leases are made by some Credit Union somewhere. They are made to proprietorships, partnerships, corporations, cooperatives, municipalities and non-profit organizations. The most common types are interim or long term financing on construction projects and income properties. These are natural extensions of their residential mortgage business.

There are a number of Credit Unions which extend lines of credit, often as part of a full service which finances inventory, equipment purchases, and real estate purchases. This full range of services is especially common on the prairies where a long history of agricultural lending has provided experience which led to extensions into commercial lending.

Most of the loans are to existing members or to individuals who were referred by existing members. Seventy-seven percent of the applications which were written up by the sample Credit Unions were accepted by the Credit Union and the client. This figure was even higher for most of the sample, since 4 of the larger Credit Unions in the sample specialize in loans requiring competitive bids on interim financing which result in acceptance rates of less than 50%. Without these 4, the acceptance ratio is 86%.

The Credit Unions are a main source of financing for the cooperative movement. The cooperatives vary in size from very small to very large, but a large number qualify as small businesses under the definitions used in this study. The cooperatives are free to obtain their financing from any financial institution, but naturally prefer to keep the financing "in the family" by borrowing from Credit Unions, provincial centrals, or CCCS. They sometimes also get financing from their wholesale suppliers such as Federated Cooperatives Limited.

The 4 western centrals are empowered to lend to cooperatives and do make such loans either by themselves or in syndication with CCCS. Many cooperatives obtain financing directly from their local Credit Union, but the number is unknown since this category of business is generally not reported separately to the centrals. In the sample, 10 Credit Unions had loans to cooperatives on their books and 7 did not.

The sample of Credit Unions made 15% of their loans to firms at the inception stage, 31% at the rapid growth stage, 51% at the maturity stage, and 3% at the decline stage. This is approximately similar to the distribution for other NBFIs described in Chapter 6. However, these figures may seriously underestimate the number of loans made at the inception stage since many inceptions may be funded by personal loans or residential mortgages which are not shown as commercial loans in the Credit Union files. Many of the loan officers pointed out that it is common for their members to start with such personal financing and gradually grow to need large commercial loans. Thus, the Credit Unions play a major role in developing small businesses at the early stages, since they often make loans at the early inception stage based on the borrower's reputation rather than on his security. They are able to do this because of a long financial and personal relationship with the member.

Eighty-one percent of the loans were obtained by existing members or by referrals from existing members. A few Credit Unions solicit commercial business directly, but most do not have the staff, or in some cases the funds, to justify active solicitation. In general, they find that the quality of the loans is much higher among those made to members than among those made to non-members.

Competitive Factors

The high rate of acceptances and the large percentage of unsolicited business implies a relationship of strong mutual loyalty and trust between the members and the Credit Union managers. This was corroborated by the loan officers who often mentioned personal contact and member loyalty as major competitive factors. Some managers are concerned that the traditional loyalty of members is eroding and that members will quickly go to other institutions if interest rates or services cease to be competitive. Interest rates and range of services are frequently mentioned as important competitive factors.

A number of special services are needed to compete effectively in commercial loans. Larger clients often need national banking services such as funds transfers, computerized bookkeeping, and foreign exchange services. Local retailers and service firms frequently need the ability to deposit VISA and Mastercard payments. These are services which Credit Unions find difficult or impossible to provide. National banking services would require some coordination of services between the provincial centrals. Charge card deposits currently can be made only at banks so some arrangement would be required between the banks and CCCS or the provincial centrals.

The banks are generally considered to be the principal competitors in commercial lending with some competition from finance companies for equipment financing. The main advantage which Credit Unions have over banks is that they are locally controlled and can be more responsive to local needs. They can adjust hours of service, terms, and other services to local needs. The borrower gets to know the manager, since managers are not moved to other branches as they often are in banks. Approval is usually quicker since the credit committee is local rather than at a regional or national office. Also, the borrower identifies with the organization, since he can speak directly to the decision makers on the credit committee.

On the other hand, banks have an image of permanence and stability and a full range of commercial services. They have more experienced personnel and better training programs. They are better able to spread risk, since the risk of a large loan is not associated directly with a single branch.

If Credit Unions are to expand into larger commercial loans, they need to develop a system for syndicating the risk of large loans. A few provincial centrals have arranged or participated in syndications, but most do not appear to consider this to be a high priority. Some Credit Unions have arranged their own syndicates with other Credit Unions, but this is usually a costly and time-consuming procedure. Loan managers have different opinions on the need for participation by the centrals. The opinions range from a strong desire to have the central provide such a facility to a deep fear that the central would develop procedures which are slow, inefficient, bureaucratic, and possibly competitive with the local Credit Union. Personnel at the centrals generally agreed that syndication would work only if the local Credit Union administered the loan and could have as large a participation as they wanted.

Application Processing

As with other financial institutions, loan applications go through initial contact, formal application, data verification, decision, and offer phases. The initial contact is usually made by a member of the local Credit Union. This contact will lead to a discussion of the proposed deal and a great deal of negotiation and fact gathering by the loan officer. Typically, the loan officer is well aware of the requirements of his loan committee, so a formal application will not be prepared until he is quite sure that it will eventually be approved. He may occasionally prepare an application at the insistence of the member applicant even if he is quite sure that it will be turned down, but this is primarily in the interests of good member relations.

Most Credit Unions have defined policies about the rate which applies to various types of loans. Thus, the rate will likely be specified at the time the application is made. The decision on small amounts of a few thousand dollars may be made by the loan officer. Larger amounts must be approved by a loan committee which may be made up of various managers or of elected or appointed members. This committee may meet daily if it consists of executives or weekly if it consists of members. Approval meetings are sometimes arranged over the phone. Very large loans and loans to directors usually require approval by the Board of Directors. In some provinces, the provincial central may have to approve large loans. Large is usually defined as a percentage of assets. The approval process is usually faster at Credit Unions than at other financial institutions because decisions are made locally by a group who quickly get to know what will be acceptable to others in the group.

The final offer tends to be a formality, since the loan officer is usually able to screen out those who are shopping for lower rates at an early stage of the process. The borrower almost always accepts offers which get as far as the loan committee.

Terms and Conditions of Loans

Loan sizes ranged from a few thousand dollars to one as high as $10 million. The upper limit is generally based on the assets of the Credit Union and is commonly in the range of $2 to $5 million. Median loan sizes range from $15,000 to $125,000 except for a few credit unions specializing in interim construction financing where the median loans are about $2 million.

Prepayment penalties are rarely required and are illegal under the Alberta Credit Union Act. A few Credit Unions specify prepayment penalties on mortgages or on very large loans. Eleven out of 17 Credit Unions require various up front, application, or commitment fees on commercial loans and others are considering instituting such fees. Usually, they are applied at the discretion of the loan officer to pay for investigations, discourage shoppers, or compensate for funds being held until needed for the loan. They range from trivial amounts to 1% of the loan.

Rates range from bank prime+0% to bank prime+4% with bank prime+2% being very common. Different Credit Unions have different policies on whether rates should depend on loan size and credit worthiness. Many Credit Unions hold that all members should get the same rate.

Loan to security ratios, covenants, and types of legal instruments vary widely, but are generally similar to those of other financial corporations. Personal guarantees, fees, and interest rates were the most difficult terms to negotiate according to most of the loan officers.

Member Education

The Credit loan managers frequently cited lack of business expertise as a major problem among borrowers whose applications are rejected. Member education is seen as an important function of Credit Unions and many managers expressed a desire to do more in this field, but did not feel that they had the time, resources, or expertise to perform this function for the minority of members who take commercial loans. Several did express interest in exploring the possibility of programs subsidized by the government. The cooperatives have formed Western Co-op College in Saskatoon to perform some of their staff training functions, so this organization might be a suitable vehicle for training members in financial management.

Government Impacts

Credit Unions, being provincial organizations, see relatively few impacts from federal government regulations. Small Business Development Bonds, the Small Business Loan Act, FBDB, and the Bank Act were mentioned several times.

The terms of the Small Business Development Bond are a universal cause for complaint. Since most Credit Unions pay minimal taxes, they are unable to benefit from the SBDB. This means either that they lose business to banks who can benefit from it, or they hurt members who stay with them instead of going to banks. The Credit Unions would like to see a program with similar benefits which are provided by some fairer method such as direct subsidies.

About 40% of the Credit Unions interviewed were registered under the Small Business Loans Act. However, they used it rarely if at all. The main reason for not using it appears to be that it involves a great deal of administration and paperwork which is more costly than the benefit which it confers. They prefer to screen their loans carefully and avoid the need for guarantees under the Act. Most of them did not want the kind of business which the SBLA might make possible.

The FBDB was mentioned 9 times by loan officers. Comments ranged from very favourable to very unfavourable. Most felt that it was a useful service to refer members to and at least 2 are either sending their own loan officers to CASE programs or are trying to sponsor CASE seminars. However, 2 made unfavourable comments. One of the loan officers said that he had referred a member to FBDB and the result had been so unsatisfactory that the member resented his effort at referral.

Several loan officers complained that Section 178 of the Bank Act allowed the Banks to take security which was unavailable to them. They wanted some provision which treated them more equally.

Comparison With Other NFBIs

Credit Unions are different from other NBFIs in a number of ways. Their relatively small size and decentralization make it possible for them to be more responsive to market needs, but it confines them to dealing with small clients because they cannot take large risks and often cannot afford the expertise needed to evaluate and administer large loans.

They often provide a full range of services and thus tend to compete with banks rather than with other NBFIs. They compete with trust companies in the residential mortgage market, but seldom see trust companies as important competitors in commercial loans. Their range of services is particularly suited for the small clients at the inception stages of a small business. Their philosophy makes it logical for them to provide education to the borrower as part of that package. Several of the loan officers and managers at the centrals expressed an interest in participating in programs to educate small business managers. Two central executives also mentioned an interest in equity participation if a suitable government venture capital program could be developed.

The low tax bracket of Credit Unions makes it impractical for them to use Small Business Development Bonds.

Conclusions

1. The federal government should modify the SBDB to make it possible for institutions with low tax rates to participate profitably.

2. Many people in the Credit Union movement see problems in the future in placing all of their deposits profitably. A move into commercial lending will provide large Credit Unions with a profitable opportunity to place any surplus funds that may exist now or in the future. However, new management skills will be needed to capitalize on this opportunity.

3. Many Credit Unions have been suffering from a matching problem recently because of the tendency of members to want to deposit for relatively short periods in savings accounts while wanting to borrow for long terms for residential mortgages. Commercial lending which is predominantly done at floating rates helps to reduce this problem.

4. The provincial Credit Union Centrals, alone or together, should develop a program to educate Credit Union managers and loan officers who are now, or are planning to be involved in commercial lending. There is clearly a critical shortage of managerial expertise in this area. Possibly an organization such as Western Co-op College can be used for this purpose.

5. The provincial centrals need to develop facilities for syndication of larger loans if they intend to keep this portion of the membership from defecting to other institutions such as banks. To be acceptable to the individual Credit Unions, such a facility will have to provide an opportunity for local participation and administration of loans along with appropriate finder's fees and administration fees.

6. If the federal government were to subsidize the provision of education in financial management to commercial borrowers, it would be consistent with their philosophy for credit unions to play an active role in the program.

Chapter 8

INTERVIEWS OF FOREIGN BANK AFFILIATES

by
Laurence Booth

INTRODUCTION

As noted in Chapter 1, when this study began Foreign Bank Affiliates (FBAs) were prospectively banks. As such, they were not included in the bank study for the SBFR, nor did they seek representation in this study of NBFIs. Yet because of their collective size and growth rate and different perspective, it was decided that they should not be complete omitted.(See Table 8-1 at the end of the chapter). Accordingly, it was decided to conduct exploratory interviews with senior officers in affiliates of six large foreign banks, using a semi-structured questionnaire designed for that purpose.(See Appendix E.) American, British and continental European banks make up the six. The interviews were conducted by the writer in early 1981. This chapter reports the findings.

In that interviews were conducted in only six of some 90 odd FBAs, one point should be noted at the outset. FBAs are not a cohesive group. Unlike other classifications of financial institutions, the designation of foreign bank affiliate is not very meaningful. The FBAs interviewed were all subsidiaries of very large international banks, but, their treatment of the Canadian market varied dramatically from a concentration on serving the financing needs of subsidiaries of parent company clients, to an orientation indistinguishable from a Canadian financial institution. Nevertheless, the FBAs projected a surprising uniformity in their attitude towards the problems of small business lending, their role in it and the effects of the new bank legislation. Hence despite the variety of their lending practices, this report can draw some meaningful conclusions that are representative of most of the FBAs interviewed. Hence, the final section provides some overall assessments of the small business financing market and the role that is being played in it by the FBAs. Some key conclusions will be added to summarize the public policy implications for the FBAs in small business financing.

Exposure to Small Business Financing

It is difficult to summarize the exposure of the interviewed FBAs as a group to the small business financing market. Quite simply, there is no common thread running through their operations. Their treatment of the small business market ranges from an emphasis on international trade and inventory financing, to equipment leasing and finally to general \$3 to \$5 million term loans. This reflects in part, differences in the positions of the individuals interviewed and different marketing positions taken by the FBAs when recognizing that they do not yet have the resources to compete head on with the Canadian chartered banks in every market segment.

For example, when discussing the types of financing made available to small businesses, the areas of specialization were given as:

- short term demand credit, secured by inventory and receivables,
- international trade financing (import/export credit) and general short term lending,
- 5 year term loans specializing in inventory financing and
- long term equipment finance and leasing.

Moreover, the relative weights given this specialization in the general small business loan portfolio varies from 45% to 100%. Hence, the FBAs are involved in most areas of small business financing. However, which particular area is given emphasis or covered at all varies from FBA to FBA. Moreover, for all of the FBAs the small business financing market is generally a small proportion of their overall loan portfolio, a figure of 5% cropped up in several interviews.

In addition to the normal lending activities many of the FBAs also provided other financial services. The most common apart from normal counselling and advice, was education in the possibilities of international financing. Specialized seminars in the eurocurrency markets, foreign exchange guidance and advice on international trade financing were mentioned. In particular, the international network of branches available to the FBAs was consistently referred to as a source of comparative advantage in providing advice and information on trade financing, credit and foreign monetary conditions. Although only established in the main business centres in Canada, it was evident that the FBAs generally had good geographic coverage in British Columbia, Alberta, Ontario and Quebec.

In generating their business, the basic dichotomy between the asset based lenders and those specializing in general trade financing was evident. The asset based lenders generally accepted a very high proportion of loan applications and received their business on a referral basis from capital goods dealers, wholesalers and other intermediaries. The loans were backed by secure collateral with emphasis on lending to firms in the mature stage of their life cycle. Although with good collateral, loans would be forthcoming to firms in the growth stage or even in the stage of economic 'decline.'

FBAs specializing in general trade financing were not so homogeneous. However, the one commonality was an emphasis on generating their own business. The fact that the Canadian chartered banks have a bank on every corner, forces the FBAs to knock on doors and solicit their own business. The proportion of business generated through direct solicitation ranged from

90% to 100%. However, given the different market segments, the acceptance ratio varied across the FBAs. At one extreme, given a target segment and direct solicitation, one interviewee FBA remarked that all loan applications were successful. Evidently, the research put into prior screening of the company was sufficient to make the evaluation of the application for a general loan a formality. On the other hand, even with direct solicitation, other FBAs with a less clearly defined market segment and a wider range of financing packages had lower acceptance ratios dropping down to 50%. All the general lenders emphasized lending to firms either undergoing rapid growth or already in a mature situation. None of the FBAs interviewed was interested in financing firms at the inception of their life cycle or at the decline stage (except if substantial collateral was available).

In considering the evaluation of loan requests and what makes a good or a bad loan, the FBAs generally struck familiar chords in emphasizing the quality of management as follows:

Small companies are management!

If the key man dies, generally the result is not good!

We'd require greater coverage with bad management.

The close identification of the small business with the principal owner and manager meant that even with the asset-based lenders and leasing firms the emphasis was on experienced managers with a strong personal commitment by the owners. The general feeling was that owners of the firm had to have more to lose than the FBA.

The other principal concerns were:

- sector of the economy the firm is in, (i.e. product and growth potential,
- general credit worthiness, (i.e. reasonable 'healthy' financial statements, and
- collateral.

Again the relative emphasis on asset based versus cash flow lending distinguished the equipment finance and leasing specialists from the general term lenders. However, the 'cash-flow' or 'growth' lenders were also concerned about inadequate capitalization. The solution offered by several FBAs was to refer the applicant to an in house or associated venture capital firm. The venture capital firm would then provide the equity that would make the loan acceptable.

In classifying a loan as marginal or unacceptable, generally the criteria were the reverse of those just listed. A firm that has lost some vital personnel, is in a weak industrial sector and has poor capitalization and potential, would obviously be exceedingly risky, especially if there did not seem to be a definite need for funds. The ways that such a marginal loan could be made acceptable were:

- shorter term
- more collateral
- higher interest rates

Essentially, these are measures aimed at reducing the loss exposure and increasing the return to compensate for the loss exposure that remains.

The FBAs were not unanimous as to which terms were the most important. Generally, it seemed that the larger general lenders were of the opinion that the interest rate was non-negotiable. In particular, several FBAs were concerned that with the growth of international banking and more efficient world financial markets, the market for larger term loans was too competitive. Hence, margins in lending to firms in the industrialized world were too narrow and did not compensate for the risk involved. This was mentioned by several FBAs as a prime reason for recent reconsideration of their role in small business financing.

On the other hand, once we move down from the general loan of about $1 to $5 million to financing the specific needs of small businesses the opinion changed. Here, the interest rate was a variable:

> Yield is the primary factor.
>
> The smaller the business, the higher the rate of interest, it's as simple as that.
>
> The rate of interest is the crucial aspect.

Generally, there was a feeling that for small businesses, it was the availability of credit that mattered and not its cost. Hence, yields were higher and more flexible in small business financing. However, that is not to say that the yield would totally compensate for risk. Several FBAs felt that there was no acceptable interest rate that could be charged to compensate for certain risks, thus the emphasis on risk reduction. One FBA put it forcibly, that for a marginal loan, the essential feature was to "find a second way out." This view was interpreted by one FBA as only lending 60% of receivables value and 50% of inventory value, where a lien would be taken on 100% of value. This would correspond to normal lending of 80% of book value. Alternatively, one equipment leasing specialist interpreted it as a shorter lease term and resale arrangements negotiated with the original equipment manufacturer. Both tactics are aimed at achieving a second way out, to reduce the risk and make the loan application acceptable.

To summarize the FBA lending to small business, one can say that there are two general segments. At the top end, there is the general term lender. Here, the market is intensely competitive, interest rates are non-negotiable and the FBAs have to aggressively compete for business on the basis of providing a better service than the Canadian Chartered Banks. At the low end are smaller specific loans usually with strong collateral. Again the competition is strong, but more emphasis is placed on the non-interest rate terms of the loan. The lenders take more time in structuring specific loan packages and because of the risk, finding a second way out. Both markets are dominated by the Canadian chartered banks which because of their national coverage are the logical first stop for a borrower. The FBAs compete in general lending by their advantages in international exposure and extra 'hustle.' In the low end the FBAs specialize and compete by being innovative in devising financing packages that make a marginal loan, that would be rejected by a Canadian chartered bank, attractive.

Sources of Funds

All the FBAs exist as financial intermediaries by issuing corporate paper guaranteed by their parent institutions. As such, their overall cost of funds is a weighted average of the corporate paper rate and parent company equity. Corporate paper comprises about 97% of their liabilities, so that the overall cost of funds was uniformly given at about 3/4% below prime. Of course, there is some change over time as the mix of 30 day and 90 day paper varies with general monetary conditions. The value of the parent company guarantee was put at about 1/8%. Most FBAs raise money in foreign money markets as well as on the Canadian money market. However, all stated that non-Canadian corporate papers was issued only to finance non-Canadian loans. None of the FBAs was allowed by its parent to have any uncovered foreign exchange liabilities; temporary mismatches when occurring, were hedged.

Two interesting minor exceptions to this general pattern were observed. One FBA was taking advantage of the provincial laws in Quebec to take in deposits that amounted to about 40% of funds raised. This allowed them to state a cost of funds of from 1-1½% below prime, since unlike the Canadian chartered banks, they were not required to post reserve requirements with the Bank of Canada against these deposits. In their words, they were "doing exactly what a bank does without being a bank." However, this situation is reduced to an historical footnote, since it is almost certain that this FBA will become a chartered bank. The second interesting observation is that one U.S. FBA felt that it had a cost advantage in raising funds in the U.S. money market. Evaluation of risk is often marginally different in the U.S. and Canadian money markets and this FBA felt that swapped funds could be raised at about 1/16 - 1/8% cheaper in New York. Overall, however the cost of funds for the FBAs is predictably similar at about 3/4% below prime.

The profitability and spreads in small business financing depend again on the marget segment in which the FBA is specializing. The general term lenders put the spread uniformly at about 1½% over cost, which would be about prime plus 3/4%. Those with smaller more specific financing policies are making some loans at up to cost plus 3%. The more specific equipment financing operations however, have larger spreads reflecting the smaller loan size and higher risk. Here, about 25% of loans are made at cost plus 4 or 5%. Essentially, the smaller the loan, the larger the spread, since a larger spread is required to make up for the basically fixed cost of writing the loan contract.

The type of lending also differentiates the FBAs as to the impact of monetary conditions. Generally, the larger term lenders are not too worried about monetary conditions. Their operations are essentially of a pass through nature. One FBA specifically referred to its operation as allowing firms the benefits of diversifying risk and using the economies of scale of a large institution. In this case, the FBA maintains a constant spread and passes through any money market changes immediately to the ultimate borrower. Several FBAs remarked that there is less resistance in the small business market to passing through money market changes and that they are rarely affected even in tight money conditions. Essentially, when money is tight, it is the Canadian chartered banks that are affected, the FBAs since they have such a small share of the market are too small to be monitored by the Central Bank. The exception to this general scenario is the fixed cost equipment leasing operations, which are hit by the 'hero-bum' syndrome of volatile short term interest rates and fixed cost leasing contracts.

Government Impacts

Because of the emphasis of the FBAs interviewed on the top end of financing for small business, there is little direct involvement in either federal or provincial small business financing programs. The only program that attracted any comment was the Small Business Development Program, where two institutions felt that they had lost substantial business. The two FBAs were unable to use the tax advantages to compete with other institutions due to their failure to earn any taxable income. Without taxable income, the tax advantages in the SBDB program are worthless. Hence, unlike financial institutions like RoyNat which generates taxable income, the two FBAs could not lower their interest rates and thus were not competitive. This was the only program that elicited any discussion. Generally, the FBAs feel that their current operations are not significantly affected either by general government regulations or small business incentive programs.

Discussion of the new Bank Act did not produce any direct implications for small business financing. Every FBA indicated that it would apply for a bank charter and as a result its costs of funds would increase slightly. However, access to term and demand deposits, however small, plus a lower rate on commercial paper (5 basis points) was expected to moderate the effect of reserve requirements. Additionally, it was pointed out that as a chartered bank, the FBAs would no longer have to pay withholding tax on foreign funds. Overall, it was felt that there would be no significant change in the competitive position of the FBAs and no significant change in their attitude towards small business financing.

Taking a longer view of the effects of the new Bank Act, several FBAs did remark that the constraints on deposit taking by the FBAs could eventually cause a portfolio change beneficial to small businesses. If the FBAs did hit the effective 8% asset constraint, then the only route to higher profits would be to downgrade the quality of the loan portfolio by taking more profitable and more risky loans. This would inevitably mean more participation in small business lending. This indirect effect was mentioned by several FBAs but rejected by one which felt that the higher administrative costs in making the loans would not create any real increase in profitability after **all** costs were considered.

The question of the profitability of small business lending after **all** costs were considered cropped up time and time again. Several FBAs mentioned that with their limited staff, they could not get involved with small loans, since the paperwork for a $250,000 loan was the same as that for a $2.5 million loan. This was the reason behind the failure to get involved in government programs, one bank put it succinctly:

> Regulation itself is still a constraint, since we can't spend time going back to the government to be reimbursed.

Hence, the big cost attached to small business lending is the time and paperwork involved. In absolute terms, the extra checking means that it is often larger than for a loan ten times as big. Additionally, many of the FBAs are relatively new to Canada and have yet to build up sufficiently large loan loss reserves to allow for a significant shift into the more risky small business financing sector. Hence, even a portfolio shift into more risky loans may not necessarily mean a significant shift into small business financing.

Prognosis, Conclusions and Recommendations

When asked to discuss the needs of small businesses and the current state of small business financing, two definite ideas emerged. The first was the failure of the Canadian chartered banks.

> The Banks are disinterested, require too much security, inflexible in terms, poor service with the accent on demand loans; staff turnover and relocation prohibits continuity.
>
> Conservative banking in Canada, everyone, not just the banks but also the non-bank financial intermediaries.

> Canadian banks are asset lenders, FBAs are more cash flow lenders. Developing companies get a better deal from FBAs, established companies from Canadian banks.

> Canadian bank is too oriented to security.

This feeling that the Canadian chartered banks have not been aggressive and flexible enough to adapt to the needs of small businesses was evident in several of the FBAs. They felt that the chartered banks generally put too much emphasis on demanding collateral and very often took all of the possible collateral, leaving none at all for any subordinate lenders making it impossible for them to come in.

The second theme was that small business financing was not a loan problem.

> Entrepreneurs expect a loan to exceed receivables and inventory, when they really need equity.

> Debt is always there, the problem is leverage.

> There's lots of money, but small businesses don't know how to borrow; they ask you to be partner, but don't treat you like a partner.

> For a new business out of 10 companies starting up 5 will go bankrupt, its a pretty risky business.

Hence, most of the FBAs felt that for a normal loan, there was no problem; a loan being money lent with little risk of default. However, many small businesses seemed to expect the financial institution to put up the bulk of the financing and then allow the entrepreneur to take all the gains, if it is a success.

Putting these two themes together, it seems that in reacting to the risk of small business lending, the Canadian banks have demanded bricks and mortar and shut down lending unless there was tangible collateral. Several of the FBAs, as noted earlier, instead are more innovative in directing the small business to an affiliated venture capital firm and then coming in with a loan, once the subordinate funds have been raised. The presence of the FBAs in small business financing has just been limited by constraints of staff and inadequate loan loss reserves.

In discussing legislation and government programs, few of the FBAs suggested increased government financial involvement. The existing set of programs was considered to be quite comprehensive. However, there was considerable annoyance at the implementation of those programs.

> FBDB is too slow and too officious; many grant programs are too easily abused by companies with adequate cash from shareholders. FBDB is old and tired.
>
> There is a need for involvement in 'true' small business financing. However,( )is often beat out by FBDB. Companies are given DREE grants when ( ) would lend them the money.
>
> FBDB is too rigid in collateral requirements, they're not really a lender of last resort, they're competing with the chartered banks.

The apparent feeling was that there was a real social need for government involvement, since some of these 'loans' are really too risky for private corporations, and as one FBA said "you can't ask a lender to take a philanthropic approach".

We have, therefore, a perceived social role, since equity is not forthcoming and loans are too risky for private institutions. However, under this general mandate, the perception is that FBDB is in fact not fulfilling this role at all, but instead is competing with the private institutions for normal business. Moreover, certain companies filling up at the public trough are giving all the programs a bad name. Hence, government policy needs not a new direction, but sterner implementation. However, parallelling this evaluation of the financial assistance, several of the FBAs felt that government help was needed more in non-financing involvement. One FBA went so far as to suggest a program of education and information with 'technical advisors.'

On a more mundane level, there were the usual criticisms of red tape and bureaucratic lethargy:

> Government is incapable of on-the-spot decisions.
>
> (We are) not interested in terms (of government programs) of participation because of red tape and time delays.

In implementing its programs, the government should staff business liaison positions with people with a business background and orientation. With a limited staff, the FBAs have little inclination to get involved in programs that offer little incentive and are staff intensive.

Some areas where the government could help small business were suggested:

- consolidated tax returns, allowing tax losses to be used in another 'business' owned by the same small business.
- pass through of the investment tax credit on leasing.
- return to full depreciation for leased asset rather than up to rental income.
- requirement in small business bank loans that the banks make the borrower aware of the Small Business Loans Act, and other government programs.

It was felt by one FBA heavily involved in leasing that the more restrictive tax laws in Canada versus the U.S. were causing implied interest rates on leases in Canada to be about 2-3% higher than for the same piece of equipment in the U.S.

Summary Impressions

To summarize the general impressions of the FBAs surveyed:

- Staff constraints limit involvement to the top end of small business financing.
- Top end is not very profitable and more interest in small business financing is evident.
- There is a suggestion that when the FBAs reach lending constraints of the new Bank Act, it will prompt more small business lending.
- Generally, the new Bank Act is not seen as seriously affecting current operations or the competitive stance of most FBAs.
- There is a feeling that small businesses have not not got a good break from the Canadian chartered banks, which have relied too much on collateral and have not been innovative.
- Government programs are good in coverage and concept but have been abused and poorly implemented. They are not fulfilling their stated objectives.
- The most pressing need for small businesses is equity financing and this cannot be provided by the FBAs. Small businesses need to be educated in finance and not led to expect risky loans from financial institutions.
- There is a role for government programs, but if it is to be collaborative with private financial institutions, then the government must recognize the staffing and time limits of the private sector and cut red tape to speed up decision-making.

Table 8-1

COMBINED BALANCE SHEETS OF FOREIGN BANK AFFILIATES

	Nov. 1976		Nov. 1980	
	millions $	%	millions $	%
Currency & Demand Deposits	31	1.4	44	0.5
Short term paper	365	16.0	1941	20.1
Investment in subsidiaries	113	5.0	624	6.5
Leasing receivables	340	14.9	614	6.4
Construction & real estate	431	18.9	605	6.3
Short term business loans	382	16.8	3308	34.2
Long term business loans	577	25.3	2266	23.4
Other assets	37	1.6	266	2.8
Total assets	**2277**	**100.0**	**9668**	**100.0**
Foreign Assets	**117**	**5.1**	**1706**	**17.6**
Bank loans	127	5.6	165	1.7
Parent loans	221	9.7	1039	10.7
Other loans	84	3.7	63	0.7
Short term notes	1422	62.5	7384	76.4
Long term notes	143	6.3	401	4.1
Other liabilities	69	3.0	209	2.2
Equity	210	9.2	406	4.2
Total liabilities	**2277**	**100.0**	**9668**	**100.0**
Foreign liabilities	**372**	**16.3**	**3063**	**31.7**

Source: Bank of Canada Review, January, 1981.

Chapter 9

IMPACT OF GOVERNMENT REGULATION AND PROGRAMS ON NON-BANK FINANCIAL INSTITUTIONS AND SMALL BUSINESS FINANCING

by
James V. Poapst

Diverse federal and provincial government measures impact on small business financing by NBFI's. This chapter is about measures in three areas - borrower protection and lender security, regulation of lenders, and federal financing assistance programs. Two such programs are reviewed - FBDB and SBLA.

Material for the chapter was obtained through several sources. Some indications of impacts of provincial borrower protection legislation were provided in the Loan Officers Survey described in Chapter 6. These leads were followed up and supplemented by special interviews of three lawyers of financial corporations. Relevant acts cited for specific provinces, and comparable legislation in other provinces, were checked for details by reference to CCH publications. References from the federal Interest Act were added. Questions about federal lender regulation were raised with the lawyers of the financial corporations, another financial corporation representative, a senior executive in RoyNat, and two trust company representatives. These discussions were supplemented by an interview with a federal regulator, and reference to the governing federal statutes. Credit unions, including provincial centrals, are subject to provincial law. Provisions governing business lending by credit unions and credit union centrals which are indirect and direct shareholders in the Canadian Co-operative Credit Society (CCCS) were assembled on our behalf by staff of CCCS. For the government programs, the legislation was reviewed in each case, and House of Commons Debates were scanned for pertinent statements of intent. For FBDB a branch manager and former loans officer were interviewed, and recent reports were reviewed. SBLA is a more limited program than FBDB, and it is treated more briefly. A synopsis of the legislation reviewed is presented in Appendix F to the study.

1) Borrower Protection and Lender Security

Impacts of Legislation

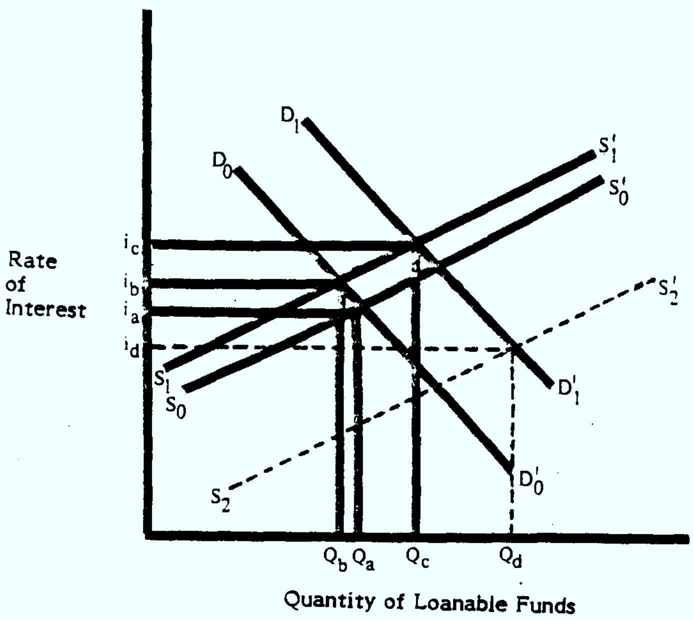
Borrower protection legislation is intended to strengthen the position of borrowers relative to lenders. Some legislation is directed to the conditions of transacting, e.g., disclosure requirements. Other legislation is directed to the powers of lenders to satisfy their claims against borrowers in default.

Changes in both types of legislation may raise interest rates for loans in a given risk class, but not necessarily reduce the amount of borrowing. Legislation on the conditions of transacting directed to changing lenders' procedures in some way (e.g. uniform and fuller disclosure requirements) may be expected to raise lenders' costs. This would shift upwards the supply curve for loanable funds. With the demand schedule for loanable funds given, the equilibrium interest rate will rise. Provided the legislation is well designed - i.e., it meets real needs of borrowers - their conditions for transacting will be improved. This would shift the demand schedule for loanable funds to the right. For example, if the imposition of uniform and fuller disclosure requirements on lenders reduces borrowers' loan transaction costs, more projects of a given level of risk would become worthwhile to undertake. The demand curve would shift to the right. This would create further upward pressure on the rate of interest. Whether the level of transactions declines or increases will depend upon the relative elasticities of supply and demand, and the relative magnitudes of the shifts in supply and demand schedules. If the legislation imposes on lenders without meeting significant real needs of borrowers, then there will be little if any tendency for the demand curve to shift to the right. The interest rate will rise and the volume of financing will decline.

The preceding reasoning is illustrated in Figure 8-1. D_0D_0' and S_0S_0' are the demand and supply curves for loanable funds before the change in borrower protection legislation. The rate of interest is i_a and quantity of transactions is Q_a. S_1S_1' is the new, higher supply schedule after the change in legislation. If the legislation does not affect the demand schedule the interest rate will be i_b and the quantity of transactions Q_b. D_1D_1' is the new demand schedule, assuming that the legislation reduces transactions costs for borrowers and consequently the quantity of funds demanded at each interest rate increases. With transactions costs reduced, at each market interest rate borrowers in total would demand more funds. The interest rate then would be i_c and the quantity of transactions Q_c. In this case i_c i_b i_a and Q_c Q_a. The condition of i_c i_a does not imply any defect or "gap" in the market.

Figure 9-1

IMPACTS OF CHANGES IN BORROWER PROTECTION LEGISLATION ON MARKET FOR LOANABLE FUNDS FOR SMALL BUSINESS FINANCING



In some circumstances it is conceivable that a change in the conditions of transacting in the interests of borrowers could lower the supply curve for loanable funds, or shift it to the right. This would occur if there were economies to lenders arising from increased standardization of contracts or if the new rules induced new lending institutions to enter the field. This possibility is illustrated in Figure 9-1, with S_2S_2' representing the favorable change in the supply curve. In this illustration the outcome is a decrease in the interest rate, i.e., i_d i_a, and an increase in transactions from Q_a to Q_d. Should such a possibility exist and not be acted upon, there would be a gap in the market.

The other type of borrower protection legislation can have similar effects. If lenders' rights against borrowers in default are effectively reduced, the supply schedule for loanable funds rises (S_0S_0' S_1S_1'). With the demand schedule given, the equilibrium interest rate rises (i_a i_b). However, the increased protection for borrowers in default reduces the risk of borrowing. To the extent that small businessmen are risk averters in the applicable wealth range the demand curve for loanable funds would tend to shift to the right. This also would create an upward pressure on the rate of interest (i_b i_c). Again, depending upon the relative elasticities, and the relative magnitude of the shifts in the loanable funds schedules, the volume of market transactions would increase or decrease. Suppose that lenders are fully aware of the significance of their reduced rights, but that borrowers are far less so. Then the supply schedule will shift to the left, but there will be little tendency for the demand curve to shift to the right. The interest rate will rise and the volume of market transactions will likely decline. This would suggest a need to disseminate information about the legal changes.

Borrower protection legislation also can be expected to redistribute the costs of borrowing between borrowers. Legislation to reduce the powers of lenders against borrowers in default raises interest rates for all borrowers while reducing the penalties for default. This reduces the difference in the realized costs of borrowing between borrowers who default and borrowers who do not. Similarly legislation governing the conditions of transacting may have less value, for example, to borrowers who know how to obtain the most attractive terms available than to those who do not. If the legislation applies to both types of borrowers, borrowing costs may increase for knowledgeable borrowers relative to the costs incurred by unskilled borrowers.

The law affecting lenders' security is not directed exclusively at borrower protection. Bankruptcy law, for example, is also concerned with priorities between claimants, including claimants for unpaid wages and salaries. Conditions governing the registration of security are for the protection of lenders. Law of this kind affects the location of the supply curve of loanable funds. It is likely to affect the demand curve only incidentally.

The Interest Act, Canada

This Act provides that an unincorporated real estate mortgage borrower may pay off his loan after five years from the date of the mortgage, subject to a prepayment penalty of three months' interest in lieu of notice. This provision discourages mortgage lending at fixed interest rates for periods beyond five years. Lenders with fixed interest rate liabilities for such periods would be vulnerable to losses on prepayments of mortgages if interest rates declined. Institutions such as life insurance companies and pension funds have liabilities which extend far beyond five years. While the liabilities are not fixed in interest rate in the way that bond-debt is, assurance that an asset will provide a specific return for a long period of time is a major attraction. Unable to offer the attraction, the unincorporated mortgage borrower presumably must off-set it in some way, such as accepting a higher interest rate. Meanwhile the borrower has his own matching problem. The period for which he would like both principal and interest payments fixed may well exceed five years

The prepayment provision for unincorporated borrowers may have had a broader impact than appears at first sight. The provision is an old one. it appears to have originated in the Orton Act of 1880, the precursor to the Interest Act (Elliott). Its longstanding existence might partly explain why trust companies did not develop a sizeable market in guaranteed investment certificates with maturities beyond five years before the Canada Deposit Insurance Company was formed. When the CDIC was formed, and provided insurance on deposit maturities only up to five years, another powerful constraint on developing the longer maturity market was constituted. The underdevelopment of the GIC market for maturities greater than five years inhibits the ability of trust companies to provide corporate business financing for longer maturities at fixed rates. Recent interest rate behavior might have limited the current demand for such financing by small business, but the demand may be restored if more stable market conditions return.

Consumer Protection Act, Quebec

Many small businesses are unincorporated. As such, in Quebec, they come under the Consumer Protection Act. Large numbers of contractors, service stations, taxicab and restaurant operators who seek equipment financing, sometimes in amounts up to $100,000 or $200,000, are unincorporated and thereby protected by the Act. Sometimes eligibility is unclear - a problem in itself.

Several provisions of the legislation discourage lending.(See Appendix E). An important one is that if upon default, the consumer has already paid at least one-half of the total obligation and of the downpayment on a conditional sale contract, the right to repossession cannot be exercised without permission of the court.

Another important provision concerns penalties for non-compliance. For a corporate lender, they can be as severe as $100,000 for a second offence (within two years) and/or six months imprisonment. Apart from their money cost, and any adverse publicity the penalties might create, their scale suggests a harsh attitude towards lenders.

Because of the legislation a number of financial corporations have ceased lending and leasing to unincorporated businesses in the province. Those that continue to offer financing are subject to less competition and have higher costs to cover. This encourages higher interest rates, if there are no countermeasures.

Interviewees referred to consumer protection acts in other provinces. Generally they were found to be a nuisance, but not problematic as in Quebec, at least for small business financing.

Realizing on Security

Several problems in realizing on security were cited by the lenders interviewed. Conditional sales acts in British Columbia, Alberta, Saskatchewan and Newfoundland require that the creditor of an unincorporated borrower in default choose between realizing on the collateral and suing on the covenant. The creditor cannot apply both sources of security. In British Columbia, the same requirement applies in the Chattel Mortgages Act. This Act also provides that where the borrower has paid at least two-thirds of the total amount required, the lender cannot seize the chattels without first obtaining a court order authorizing it. At least five provinces have legislation to protect essential personal property from seizure that includes the debtor's "tools of trade."(See Appendix E). This means that a chattel mortgage on, say a contractor's truck might not be enforceable. The amounts are small, ranging from $2,000 in Ontario to $5,000 in Alberta and $6,500 in New Brunswick. Nevertheless they are significant for small business loans because the incidence of default can be relatively high.

Certain provincial laws can create priorities over the claims of secured lenders. An example is the right of employees of an execution debtor to claim up to three months unpaid wages and salaries ahead of certain secured creditors, and to share pro-rata with other creditors for additional claims on proceeds remaining in the sheriff's hands. Such rights increase the risk of secured lending particularly in labour intensive firms. The rights apply in British Columbia, Alberta and Manitoba.

The federal Bankruptcy Act is currently under review. This in itself creates uncertainty for lenders.

Lenders' costs on loans in default are compounded by the time required to realize on security. From the first default, time is required to determine whether legal action is appropriate, to give the borrower due notice of action, for court proceedings if required, to take possession of the property, to sell it and to receive settlement. The total time required may range up to three months if the claim is not contested. If the claim is contested additional months are required, especially if the remedy is through suit. In Saskatchewan, time required for realization is reported to be relatively long because of the requirement to serve notices personally, delaying procedures available to borrowers and the activities of the mediation board. The longer the time required to realize on security, the higher the opportunity costs of interest earnings foregone and the greater the uncertainty over the resale price of the security.

To realize on security, it must be taken in the first place. Nova Scotia and New Brunswick lack a central registry for contracts and liens. This makes it cumbersome for taking security through conditional sales contracts and chattel mortgages, particularly the latter. Registration of chattel mortgages is by location of the collateral. To check for an existing mortgage against the chattel would require a search in every county registry office in the province where the lender might have occasion to enforce the mortgage, if there is default. Similarly, to make the security effective, the chattel mortgage would have to be registered in those offices. For conditional sales contracts, location is based on the borrower's county of residence, so that problems arise only if borrowers move from one county to another. With businesses this is less frequent than for the chattels they own.

Implication

The preceding references to law affecting borrowers' and lenders' interests are not complete, but are indicative. The interviewees felt that the legal system requires expensive documents and contracts, and that the courts were very lenient to debtors. There are laws which undoubtedly lenders would wish to have changed. It is conceivable that the existing diverse bundle of federal and provincial acts and regulations represents an optimum compromise from the standpoints of both lenders and borrowers. More likely some of the changes lenders wish to have made would be in the borrowers' interest too. The basic point to be made, however, is not that the laws must necessarily be changed. It is that the laws affect what should be viewed as "reasonable terms and conditions" for lending to small business, especially unincorporated business. There is a need to protect debtors and lenders are required to adjust to those needs. The adjustment involves a cost, typically a higher interest rate than otherwise would prevail.

2) Regulation of Lenders

RoyNat and Other Financial Corporations

Major considerations to a lending institution are the eligibility of borrowers, portfolio limits on types of financing, terms of lending, and its ability to raise funds at terms that enable it to compete effectively in asset markets. RoyNat and the larger financial corporations are federally incorporated and are regulated by the Investment Companies Act (S.C. 1970-71, c. 33 as amended). Generally, it appears, they do not find that their governing legislation inhibits small business financing.

Lending to both unincorporated and incorporated business is authorized and selection of borrowers is restricted by the dictates of prudent lending. Specific earnings tests and other acceptance criteria are not prescribed for lenders. Portfolio limits on small business financing, such as the proportion of assets that may be so invested are not applicable. Nor are limits upon interest rates, fees, periods to maturity, amortization and loan-to-security ratios.

The standard forms of security may be taken on capital goods and debenture financing with floating charges and appropriate covenants may be undertaken. Investment companies are at a competitive disadvantage compared to banks in that they have no legal provision comparable to Section 178 (formerly 88) of the Bank Act for taking security. If they had such authority, they would still be at a disadvantage in using it in that they would not have the borrower's chequing account which is integral to monitoring the security. However, the point is noteworthy since it is an element in the balance of competition between lenders.

Finally, the investment company's costs of financing are governed by conditions in the market place. It is not the Act that restricts financial leverage to the ratios that are used. They are privately negotiated.

Trust Companies

Most major trust companies are federally registered. The federal Trust Companies Act comprises the predominant regulatory legislation for the industry. At time of writing, the legislation is subject to review so that statements about its impact are necessarily tentative.

Trust companies traditionally have not sought to engage more than minimally in small business financing. The principal outlet for their intermediary funds is residential mortgage loans, but the industry is faced with a prospective decline in the relative importance of housing finance and seeks increased access to other financial markets. It also seeks higher limits on financial leverage to compete more effectively in both existing and new asset markets.

The trust companies can provide some business finance through residential mortgages. The housing stock probably constitutes the biggest component of our reproducible national wealth. Large increases in the price of housing in recent years have expanded owners' equity in the existing housing stock. Remortgaging it at higher levels potentially could provide sizable amounts of equity capital for small business, if the owners wished to do so. There are no legislative impediments specific to this purpose of residential mortgage lending.

Trust companies do not have authority to make loans secured primarily by current assets. The conventional reason for prohibiting such loans is that trust companies hold large amounts of corporate securities in their estates, trust and agency (ETA) funds. Lending their intermediary funds to companies whose securities are held in their ETA funds could place a trust company in a situation where the economic interests of the two sides of its business might diverge. For example, there might be a temptation to make an otherwise unacceptable loan to a company in difficulty whose shares were held in ETA funds. Should such a condition occur, making the loan could mean sacrificing the best interests of the guarantee fund to the benefit of the ETA account which held the shares. Also, the requirements of prudent lending often involve the disclosure to the lender of information about the borrower that is not normally available to investors. Trust company investment managers could be perceived to have an unfair advantage in the market.

Trust companies need not be precluded from current lending if the potential for divergence of its economic interests can be ruled out. Presumably, this could be done by prohibiting a trust company from investing any of its funds under adminstration in the shares of a company that borrows from it to finance a significant proportion of its assets. Shares of private companies are not traded on stock exchanges and over-the-counter markets. The shares of small ones normally come under the administration of trust companies only in such situations as the administration of an estate. In general, they do not present a potential for divergent economic interests. The selective prohibition then would restrict a trust company's authority to lend to large companies, while leaving its authority to lend to small companies substantially unaffected. The selective prohibition would have the added attraction that trust companies would not automatically have to dispose of their loans to successful small companies that grow large enough to go public. If the borrowers added sufficient assets financed by other sources, the trust companies could even hold the shares. In marketing financial services the potential for a long term relationship is important. Because of the high turnover among small businesses, it is desirable that those who provide their financing not be ruled out of lending when those that succeed grow large.

The trust companies are seeking authority to make loans secured by current assets to unincorporated businesses and corporations. They propose that the aggregate of such loans, together with consumer loans, not exceed

25% of their own total assets. Also, they propose that a loan of this kind not exceed 25% of the borrower's total assets. Presumably, this latter limit would be lower where the lender also holds the borrower's marketable securities. At the end of 1979, federally registered trust company intermediation assets amounted to $17 billion. Admitting them to current lending would increase access of a major financial institution to business financing.

Trust companies are restricted in the financing they can provide to small businesses in the latters' early years of operations. Mortgage loans and mortgage bond investments can be made to startups. But other forms of indebtedness, preferred shares and common shares require earnings or dividend records of five years or more to be eligible investments of intermediation funds. The restrictions are relaxed for some types of investments under the basket clause, to the extent of 7% of guaranteed funds, 15% of company funds and 7% of company plus guaranteed funds. Investments which are not expected to become eligible under normal provisions and shares which are not readily marketable are relatively unattractive as "basket clause" investments.

Federal trust companies generally perceive the financial leverage of their intermediation funds to be limited by legislation rather than the market place. Authority to raise the debt/equity multiple, they believe, would lower their overall cost of financing. This in turn would let them compete more effectively in all their asset markets.

To obtain approval for their borrowing power to be increased beyond 20 times equity, trust companies must meet specified standards for earnings, liquidity, and holdings of "high quality" assets. These assets are defined as certain liquid assets, government bonds, secured loans and residential mortgages. Holdings of such assets together must be at least 66 2/3% of total assets.

Trust companies are doubly interested in the prospective slowdown in the rate of growth of residential mortgage lending. New asset markets must be found, if high growth is to be maintained and a revised definition of high quality assets is required, if favourable debt/equity multiples are to be maintained, let alone increased.

The trust companies observe that the banks are free to operate at higher debt/equity levels. Including foreign currency liabilities, the average ratio was 32.4 for chartered banks at end of 1980. The ratio for trust (and mortgage loan) companies was 17.5, with ratios for stronger companies ranging up to 25. Some trust company executives believe that like the banks their companies should not be subject to a maximum ratio. The market place should govern. From a regulatory standpoint this view would be more easily accepted if trust companies could demonstrate that unrestricted financial leverage ratios would not jeopardize their creditors' interests. Demonstration of this, however, is difficult if a significant reorientation of operations is in prospect. Nevertheless, an official statement of standards to be fulfilled over some specified number of years would assist corporate policymaking at this juncture.

Trust companies are authorized to invest in securities and make consumer loans. The spreads on investing in securities tend to be small. Consequently, there is less need for intermediation services in securities markets than in loan markets. Consumer loans are attractive and are a natural complement to taking personal deposits. Consumer loans will compete with business loans for a share of trust company intermediation assets.

Credit Unions

Credit unions are independent, locally oriented, democratically controlled organizations, which differ widely in size and character. They are subject to provincial regulation which varies from province to province.

Business loans may include more than loans to business made for business purposes. Loans secured by personal assets or personal guarantees may be used for business purposes. Similarly loans made to businesses may finance withdrawals for personal purposes. The two latter types of loans may be viewed as business lending by credit unions. Currently business loans are made in all provinces except Newfoundland.

Business lending by credit unions is generally governed by the provincial credit union Act and Regulations, and by a special Business Loans Manual or policy. Reflecting the credit union's primary orientation to personal finance and the risks of business lending, business lending is legally and administratively circumscribed in several ways, including:

i) the types of businesses which may become members,
ii) a requirement that all business loans, or business loans greater than some amount, be approved by the provincial stabilization Board (or its equivalent or central,
iii) other limits upon the amount of the loan to any one borrower,
iv) limitation of the aggregate amount of the credit union's business loans outstanding.
v) a requirement that authorized security be taken for each business loan, subject to specified exemptions.

Businesses are eligible to become members in Saskatchewan, Manitoba, Ontario, Nova Scotia, and Prince Edward Island. Generally, they may be unincorporated or incorporated, co-operatives or non-co-operatives. Generally too, some form or degree of commonality must be obtained between the employees and owners of the business and the members of the credit union. This may take the form of a majority of the employees and owners of the business being members of the Credit Union.

The location of authority to limit the maximum loan to a single business borrower varies by province. Upper limits may be specified in the Act or Regulations, be left to the Reserve Board or equivalent organization, the Standard By-laws, the provincial central, the credit union's board of directors, or some combination of these. In Quebec, no limit is specifically presented. In all provinces except Ontario, however, loans over a certain amount must be approved by the Stabilization Board or by the central. When calculating the limit for any one business loan, other outstanding business loans are taken into account.

Otherwise in determining the maximum allowable business loans three different approaches are used. In Prince Edward Island, the limit appears to be based on the value of the collateral. In New Brunswick, it is 5% of assets. In the other provinces, it is a proportion of the credit union's share capital (or net worth) and deposits. In Ontario, Manitoba and New Brunswick, the limit is 10% of members' equity and deposits, or a close equivalent. In Saskatchewan, the Standard By-laws set a limit of 5%, but other controls on procedure recommend or authorize other limits, including higher ones. Members' equities and deposits together normally provide a high proportion of credit union funds. For total credit unions in the province, they were about 95% or more of total assets in each province in 1978, except Prince Edward Island.(Statistics Canada, Credit Unions, 1978). Equity and deposit based limits thus approximate asset limits.

In seven of the nine provinces in which business loans are made, a ceiling is placed on all or part of the business loan portfolio, or may be imposed. Limits are provided in Saskatchewan, Ontario, New Brunswick and Nova Scotia. They vary widely in form and proportionate amount. The Saskatchewan Act lumps business loans with mortgage loans for the purchase of real estate and limits the total to 25% of capital and deposits, unless the credit union authorizes otherwise by supplemental by-law. In Ontario, loans to corporations and partnerships are limited to the greater of 7% of unimpaired capital, deposits and surplus or such amount the provincial Director approves, up to 15%. In Alberta and Quebec, the credit union's Board of Directors has authority to set limits; in Prince Edward Island, the central in its capacity as Inspector of Credit Unions has the power to set limits, if necessary.

In Quebec, security for business loans may be required at the discretion of the credit union's credit committee. Otherwise it appears that exemptions generally are for amounts of $5,000 or less. In Saskatchewan, the Mutual Aid Board may authorize higher amounts. In Alberta, depending upon their operating performance, credit unions may apply for authority to make unsecured loans, but it appears that none has.

In short, members may borrow for business purposes, some businesses may become members, there are credit union size-related limits on individual loans, those for more than minimal amounts must be secured, and the larger ones at least must be approved by some central body, and the aggregate portfolio is limited to some minority of total assets.

Given the traditional orientation of credit unions, the business lending provisions do not appear unduly restrictive. The size limits on individual loans are such that diversification is more likely to be the binding consideration. If the Stabilization Board or central is organized to deal with applications promptly the requirement for their approval should not unduly prolong the lending process. As credit unions prove themselves in business lending, exemption limits for central approval can be raised. The requirement of some form of commonality between business and individual members encourages credit unions to develop combined service packages for businesses, their owners, and employees. As with any other activity, the credit union must know the business of small business lending. This means not only being able to assess default risks. Provided his finances are maintained in order, the small business borrower must be able to rely on the lender to supply and accept funds on a flexible basis. To compete effectively for small business accounts, credit unions must manage their own liquidity in such a way that the loan tap is not turned on and off for business members. The legislation and other regulatory procedures do not prevent this. The total loan to any one business member and the total size of the business loan portfolio must merely be kept sufficiently below their respective maxima that loan demands can be satisfied. In managing liquidity, credit unions now not only have the benefit of provincial pooling, but a recently much augmented national pool as well. The assets of CCCS were increased from $ 55 million in 1976 to $740 million in 1980.

The credit union that meets the other requirements of small business lending is at a competitive disadvantage in one respect as a result of legislation. That is in the taking of security. Credit unions are not permitted to take security on the basis provided for the banks under section 178 of the Bank Act. In principle, there appears to be no reason why banks should be the only institutions that have access to security on this basis.

Insofar as they are prepared to make business loans, their philosophy, size, and regulatory constraints orient credit unions to small business financing.

3) Government Financing Assistance

A recent compilation of federal and provincial financial assistance programs for which small businesses are eligible, listed 39 non-tax measures plus nine federal tax assistance measures (ITC memo). The non-tax measures provided assistance in the form of loans, loan guarantees, interest subsidies, equity financing or grants. The two major non-farm business programs of the federal government are FBDB and the Small Business Loans Act Program.

FBDB's Mandate

Including its predecessor, the Industrial Development Bank, FBDB has a history of over 35 years of lending to small and medium sized businesses. Over the years, it must have contributed much to the development of skills in term lending to small businesses in Canada. It has done this both in its own organization and the private sector as the latter sought loan officers with IDB/FBDB experience to help develop private lending in the area. Moreover, along the way it has undoubtedly enhanced the financial management skills in many of the small businesses which have applied to it for funds over the years. This contribution, first cited in IDB reports many years ago, is now formally expressed as part of FBDB's mandate. FBDB offers both financial and management services to small businesses. The former includes loans and loan guarantees, security purchases and underwriting. The latter includes management counselling and training, information and advice. Its past contributions, the evolution of the private market and our own research create several concerns about FBDB's future financial services operations. That these concerns devolve partly from the organization's past contributions does not obviate the need to address them.

i) The delineation of small business

In Chapter 3 and Volume II, Appendix A estimates of small business are presented which are based on an analytically relevant approach to defining "small". If that rationale is accepted small business is very small indeed and is variable by industry. Also, what is small depends upon the purpose. The more carefully small business is delineated in relation to the purpose of a financing program, the less likely the program is to subsidize the wrong borrowers or to make loans outside its real mandate. The current offical vagueness about what is small must create uncertainty among private lenders.

ii) "Reasonable terms and conditions"

"FBDB is empowered to provide financial assistance to businesses which are unable to obtain financing from other sources on reasonable terms and conditions."(Annual Report for 1980, p.4) What such terms and conditions are is not altogether clear. Recently, however, it appears that they are seen by FBDB as below those necessary to recover its out-of-pocket costs, without providing a minimum competitive rate of return on equity. The Report for 1980 states:

> It is simply no longer possible, considering the bank's special mandate and financial base and its need to obtain financing almost exclusively from the capital market, to continue on a **cost recovery basis.** The high risk factor pertaining to a large part of the bank's clientele, additional costs relating to rollover of debt, and the growth of the investment portfolio, have placed increased demands on the bank which it cannot afford **without setting untenably high interest rates.** (p. 6. emphasis added)

Judging by its recent reported experience, "cost recovery" does not include the opportunity cost of equity capital. In its first three full fiscal years as successor to IDB, FBDB reported a small positive net income.(See Table 9-2 following). Its maximum return on book equity, which occurred in 1977, was 1.4%. This was after provision for losses, but with no income taxes to pay and not unfavourable borrowing rates. In 1980, the rate of return was -14.7% and the reported net loss was $29.3 million. In the prevailing circumstances, it appears that "untenably high interest rates" would be required merely to recover out-of-pocket costs.

Just why promised interest rates sufficiently high to recover such costs would be "untenably high" is not stated.[1] Analogous terms and conditions of transacting in non-financial industries would be considered unreasonably low by economists because the promised rates do not provide for the opportunity cost of equity capital, including retained earnings. Such low rates would promote the misallocation of capital.

iii) The Bank as competitor

"The bank complements the activities of other lenders and its role is influenced and indeed is circumscribed by the activity of other lending institutions."(Annual Report, 1980, p.4). The bank is a "supplemental lender." (Ibid.) We have not found official expressions of the mandate which state that the bank inescapably is in competition with private lenders. It is. So long as the bank's presence is known to borrowers, private lenders must take that presence into account in deciding on applications for financing. Nor is it clear just what the policies of the private lenders must be for their rejections to qualify borrowers for FBDB. Lenders differ in their policies, so that rejections obtained from, say, two lenders do not necessarily indicate that no private lender would lend on reasonable "reasonable terms and conditions." For example, credit unions and caisses populaire are authorized to make business loans, but many are not active and continuous business lenders. An application will be rejected if the applicant is not a member, the amount of the loan is too large, or loanable funds are scarce and being conserved for other purposes. With a little knowledge, many applicants can find two lenders who will not lend to them at "reasonable terms and conditions," especially if the latter really means terms and conditions insufficient to recover out-of-pocket costs. Nor is it clear why a supplementary lender should use "after acquired" clauses in its contracts. Finally, one may ask how "supplemental" is determined if the presence of the bank discourages the entry of venturesome lenders. "Supplemental lender" is a specious concept.

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1 It is assumed that "untenably high rates" does not refer to **expected** rates.

Table 9 - 1

DISTRIBUTION OF AMOUNT OF LOANS APPROVED BY FBDB AND MINIMUM SIZE OF FINANCING ACCEPTED BY SELECTED PRIVATE LENDERS BY TYPE OF FINANCING, 1980

Size of Loan Approved by FBDB or Minimum Size of Financing Accepted by Private Lenders	FBDB[a]	Private Lenders[b]											
	% of Total Amount of Loans Approved	Long term Loans[c]				Mortgage Loans				Lease Financing			
		Companies		Offices		Companies		Offices		Companies		Offices	
		No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
$50,000 and under	30.7	6	23.1	61	61.6	5	38.5	59	80.0	5	31.3	74	74.0
$100,000 and under	53.0	10	38.5	73	73.7	6	46.2	60	82.2	9	56.3	85	85.0
$500,000 and under	90.9	21	80.8	88	88.9	11	84.7	66	90.4	12	75.0	90	90.0
Total	100.0	26	100.0	99	100.0	13	100.0	73	100.0	16	100.0	100	100.0
	$866.4 mil												
Minimum Size of Loan		9		37		6		33		8		39	

a Loans approved for fiscal year ending March 31, 1980

b Compiled from the General Financing section of the Sources of Funds Index. This section is much more limited than the other sections, being compiled from yellow pages of telephone directories and other partial sources. Companies that provide more than one type of financing are counted for each type they provide.

c Loans over seven years.

Sources: FBDB, Annual Report, 1980; SB Capital Corp. Ltd., Sources of Funds Index, 1980.

iv) "Lender of last resort"

Some indication of respective domains of FBDB and private institutions is provided in Table 9-1. The table compares the distribution of amount of loans approved by FBDB, by size, with the minimum amounts of financing acceptable to private lenders as reported in the Sources of Funds Index, General Financing section. SB Capital Corporation Limited, which compiles the Index, concentrates much more on the venture capital area than the sources of funds shown in Table 9-1. Consequently, the list is far from complete. It mostly consists of corporations affiliated with foreign financial institutions; it does not include chartered banks. Separate classifications were prepared for long term loans (35 companies), mortgages (19 companies) and lease financing (24 companies). Two-thirds or more of the companies listed reported a minimum acceptable amount for each of the three types of financing 26, 13, 16 respectively. (Minimum acceptable amounts of course say nothing of the volume of lending at those amounts.)

For fiscal year ending in 1980, 53% of the total amount of loans approved by FBDB was for amounts of $100,000 or less. Of reporting companies, fewer than one-half reported minimum acceptable amounts in this size range for long term loans (38%) and mortgages (46%). For leases the proportion was higher (56%). The companies in this size range, however, had a majority of the offices providing each type of financing, from 74% for long term loans to 85% for leases. Assuming that some non-reporting companies had minima below $100,000 and considering the sizeable number of omissions from the tabulation including the chartered banks, it appears that a significant number of major lenders operate in the lower size ranges in which FBDB is active.[2] Recognizing the influence of travel costs, this lending probably is focussed more on large and medium sized centres than in small and frontier communities.

On second reading of Bill C-20 in 1980, more than one member of parliament referred to FBDB as a "lender of last resort." (See House of Commons Debates, May 23, 1980. p. 1361 and p. 1370) This is an unfortunate inaccuracy. If there is an operational two-rejection procedure, FBDB is a lender of "third or subsequent resort." If the procedure is not followed, FBDB becomes in reality a lender of first or second resort. Meanwhile, in financial institutional usage, the expression implies a right to borrow, possibly a condition of distress and perhaps that the savings of many small investors are in jeopardy. These are not the usual conditions of applicants for FBDB financing, according to our findings.

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2 In the Survey of Financing Files, it was found that 60% of the number term financings was for amounts below $100,000.

Table 9-2

SELECTED RATIOS AND AVERAGE SIZE OF FINANCIAL COMMITMENT MADE
FBDB AND ROYNAT, 1977 - 81

Fiscal Year Ending In[a]	Gross Income		Net Income Before Tax		Staff Cost		Net Income Before Tax as % of Net Worth		Average Size of Commitment Made $000	
	FBDB	RoyNat	FBDB[b]	RoyNat	FBDB	RoyNat	FBDB[b]	RoyNat	FBDB	RoyNat
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
1977	11.0	11.4	0.2	2.2	2.0	0.7	1.5	25.7	46	222
1978	11.6	11.4	0.1	2.1	2.3	0.7	0.7	26.2	48	292
1979	11.2	11.4	0.0	1.8	2.2	0.8	0.3	23.3	54	282
1980	11.2	12.0	(1.5)	1.5	2.2	0.7	(14.7)	21.5	52	334
1981	13.0	12.7	(2.2)	1.0	2.3	0.7	(23.2)	14.9	61	274

a March 31 for FBDB, April 30 for RoyNat
b ( ) denotes loss

Source: Annual Reports

v) If there is an economic supply gap, is it significant?

Major steps that would reduce an economic supply gap in long term loan and lease financing were taken under the Bank Act of 1967. The prohibition against non-residential mortgage lending by banks and the 6% ceiling on interest rates on bank loans were removed. In recent years, if a gap in long term and lease financing existed, it appears to have declined, even to have become negative. Indicators of such a change are the increase in the number and activity of competitors, both private and public, the lower proportion of realty loans and fully secured loans now made by FBDB, its many borrowers with little or no experience in operating their businesses, the importance of smaller and frontier communities in the demand for FBDB loans, and the recent rise in venture capital investments (Annual Report 1980, p.4). Also, the proportion of loans approved for $50,000 or less decreased only from marginally above 75% to marginally below 70% in recent years, despite the increases in prices of capital assets. In referring to amounts of $50,000 or less, the bank reported that "the interest income which the bank receives from these loans, net of its cost of funds, is now not sufficient to cover their administration and related losses."(Annual Report for 1980, p. 4). For loans of this size and risk, the impacts of fixed lending costs and statutory protection of borrowers in default is greatest. At the high rates required to cover lenders' costs there might be little or no borrowing. But this in itself would not mean that there is a gap in the capital market any more than the absence of retail sales of milk at 10¢ per litre means that there is a gap in the food market.

A five-ratio comparison of the performance of FBDB and RoyNat for the fiscal years ending in 1977-81 is presented in Table 9-2. The annual ratios of gross income to total assets for the two companies remain close together throughout the five years. With fixed-rate term lending, gross income is influenced by interest rates charged in a number of years. The mixtures of fixed and variable rate lending is not known. In any case, the similarity of the ratios over the five-year period suggests a similarity in interest rates charged. RoyNat's annual ratio of net income before taxes to total assets was consistently higher than FBDB's. Differences ranged from 1.8 to 3.2 percentage points. Differences in the annual ratios of staff costs to total assets account for one-half or more of the differences in the ratios of net income before taxes to total assets. Assuming most staff costs are incurred for lending operations, differences in such costs can be attributed to the presence of important fixed costs in making loans. Over some range of loan sizes it may take even less cost to process larger loans than smaller ones. This could occur where the larger borrowers kept better accounts of their activities and position. During the period, the annual average size of financing commitment made by RoyNat ranged from about 4½ to nearly 6½ times that for FBDB.

RoyNat pays income taxes; FBDB does not. For this reason, comparisons were made of the ratio of net income before taxes to net worth. Annual ratios for RoyNat ranged from 14.9% to 26.2% compared to

-23.2% to 1.5% for FBDB. Besides lower staff costs, lower provisions for losses, especially in the last two years (not shown) contribute to the higher ratios of RoyNat. Fixed costs of lending weigh heavily on a portfolio of small loans and the costs of the high risks of lending to small business are real.

vi) Double standard or subsidy?

Altogether there is some suggestion of a double standard in public policymakers' attitudes about "fair and reasonable terms and conditions" of transacting, given the levels of risk involved. In non-financial industries, a risk-inclusive competitive rate of return on equity is acceptable; in small business financing perhaps it is not. Alternatively, there may be a belief that small business should be subsidized. If so, the obvious questions are (1) why? and (2) Is credit at sub-market terms the best way to deliver it?

FBDB Management Services

The thrust of FBDB in the direction of management services is consistent with the often repeated assertion that the primary problem of small business is management and not financing. The claim appears in management literature and research studies on small business. "One major conclusion drawn from the study of small business is that the overriding cause of failure can be attributed to management incompetence."(Litvak and Maule). Loan officers interviewed in both private and public institutions for this study support this view. Our survey of small business managers provides evidence of the importance of financial management skills. Management skills, acquired through formal instruction or otherwise, by themselves are insufficient to produce successful enterprises. But at least management skill development is directed to what is widely agreed to be the primary cause of failure. It is difficult to argue that subsidized financing is a better way to improve managerial competence.

It is noteworthy that FBDB's total appropriation for management services was $15.3 million for fiscal 1981. This was only 33% of salary and employee expenses for financial services. It was also equal to 34% of the losses reported for financial services for the year. Merely avoiding losses of the 1981 level would finance nearly three years of operations of management services at the 1981 level.

Small businesses have to cope with the limited divisibility of human capital. They are not large enough to employ a sufficient number of executives to permit much specialization. For instance, Thornton (Chapter 4) reports that only one in five of some 300 small firms surveyed had a full time financial manager. Of necessity, there is much reliance on general--purpose owner-managers, with specialist services provided part-time by accountants and consultants or not at all. Learning how to use specialist support staff effectively is a skill of primary importance in small business management development.

Finance is only one subject that small business managers need to know more about. It is noteworthy that a number of term lenders - RoyNat, chartered banks, FBDB - offer instructional services and materials to small business. It is also noteworthy that unless billed separately, what can be viewed as borrower learning costs are sometimes included in term loan interest rates.

Management support services for small business are expanding. Besides the long-standing professionals - accountants and lawyers - large management consulting firms such as Woods Gordon and Coopers and Lybrand have opened small business consulting departments. There are many small independent consulting firms, including those affiliated with business schools. Some business schools now offer courses in small business. Such services not only provide assistance that is broader and hence often more relevant than financial assistance. In respect to financing, they work on the demand gap.

SBLA

The Act provides for government insured term loans by private lending institutions to small businesses to assist them in acquiring or improving eligible types of fixed assets. Eligible borrowers must have gross annual sales below $1.5 million and be engaged in manufacturing, trade, communications, construction, transportation and service business excluding legally recognized professions. Maximum loan terms are: amount, $100,000; loan-to-value ratio, 80% or 90% for land; term, 10 years; interest rate, chartered bank prime +1% and varied with it. Chartered banks and most types of NBFIs are eligible to seek qualification and designation as banks for purposes of the Act. No charge is made for the insurance and lenders receive credits on a cumulative basis that can provide a high level of protection against losses. The government's approach to administration appears to be to minimize red tape and to avoid lengthening the transaction process.

The Act differs from FBDB's approach in that there is a definition of small business, no vague requirement of "reasonable terms and conditions," and reliance on private lenders. The definition of small does not appear to be based on a clear economic rationale and is not industry variable. But it is a step forward from having no definition. Specific limits for small and for the terms of loans facilitate transactions compared to a process based on inability to obtain private funds on reasonable terms and conditions. As noted in Chapter 2, "gaps" can be viewed in terms of the length of the transaction process and where liquidity is the urgent consideration, it can be desirable to trade off speed of transaction against contract terms. The free insurance provides a subsidy, which is shared between borrowers and lenders. The more borrowers obtain terms more favourable than they would on an uninsured basis, the larger their share. The less the lenders pass on the benefits of the free insurance through easier terms, the higher the proportion of the subsidy they preempt. The higher the standard of competition, the lower the proportion lenders will preempt.

A noteworthy feature of the legislation is that it is designed for banks. The maximum interest rate is based on chartered bank prime. That rate is set on the basis of the circumstances of the large banks. Also banks deal in a broader range of products with their business customers than do NBFIs. In setting interest rates on their loans, they can allow for the benefits derived from the other services. There is no provision for a fixed rate alternative available.

Our main concern is that the program does not address the problem of management.

The Possible Case for Financing Aid

Our view is that a pervasive economic supply gap in long term loan financing does not exist. There are some gaps caused by regulation that deserve attention. But they are not large and are not difficult to deal with. In addition, there is a particular market segment in which government might wish to facilitate financing. It is the small firm which is not yet able to borrow on the basis of its reputation and which uses fixed assets for which there is not yet a resale market. For businesses without an established reputation, lenders rely on specific fixed assets for security. In competitive industries, there are alternative users of important types of fixed assets. For some specific types of fixed assets there may be users in many industries. In these instances, there may be resale markets in the specific goods. For new types of assets or highly specialized types of assets, a resale market may not exist. Asset-specific financing may not be available, except perhaps from the goods supplier. If it is important socially that the firms which rely on the assets develop, or that use of the assets spreads, there is a possible role for government in subsidized financing. Once the loans are seasoned they might be sold to private lenders.

Conclusions

1. Borrower protection legislation governing the conditions of transacting loans and settlements in default affects the structure of interest rates. The impact of such legislation upon interest rates is high for small loans. This is not a judgement against such legislation, but it does affect the minimum terms and conditions in the market place that can be considered "reasonable."

2. The Interest Act inhibits mortgage lending to unincorporated borrowers at a fixed rate for terms beyond five years. The resulting gap does not appear large under present circumstances when most term lending is being conducted on a floating-rate basis. But its removal would increase the borrowers' options at least in times when loan markets are more settled.

3. There does not appear to be a reason to continue to deny trust companies access to current lending. The possibility that they could have non-optimally reconcilable dual interests in a borrower can be protected against by appropriate legislation, especially for small business.

4. Financial corporations, trust companies, and credit unions are all at a disadvantage compared to banks, in taking security on current assets. Non-bank institutions cannot take security on the convenient basis provided for banks under section 178 of the Bank Act.

5. IDB and its successor, FBDB, did much to develop term financing to business in Canada. Their contribution has assisted the private market to develop to the point where FBDB should turn to other activities. By our delineation of small business and our conception of gaps, a significant amount of FBDB loans are made to large businesses and/or at "too favourable terms and conditions." In short, the private market can do most of the job that should be done if scarce resources are not to be wasted.

6. FBDB's thrust in the area of management services at long last recognizes what many participants and observers of small business have said. The basic problem lies in the management of small businesses.

7. Our main concern with SBLA, as with other government financing agencies, is that they are directed to the symptom and not to its cause.

Chapter 10

CONCLUSIONS AND RECOMMENDATIONS

by
James V. Poapst, Daniel B. Thornton, George H. Haines Jr., and Len Fertuck

The conclusions are first set out in relation to each study objective and then recommendations are made.

Objective 1:

to identify key segments of small business (as distinct from large) to determine their distinctive needs for financing and related financial services.

Conclusions

1. Financing is without doubt a less important problem to small business than marketing, production, inflation, personnel, and cost control. Evidence from the survey of small business managers is clear on this point.

2. A service related to financing is the service of financial management. Problems experienced by small business with respect to financing appear to result not so much from immutable characteristics of the businesses themselves, such as industry, location, or size as from the absence of a full time financial manager who is willing to plan the firm's financial strategy and able to devote the time that is necessary to maintain good relations with the sources of financing. This is not to say that these other variables were unimportant: they turned up quite often in different combinations either in concert with financial management depth or without it. But this one variable - absence of a full time financial manager - was the one that turned up most often. It seems to provide the most significant overall segmentation of small business from the standpoint of financing.

3. This study made a start at identifying small business segments by industry in Canada in terms of the size at which they cease to be at a cost disadvantage in relation to other firms using the same processes in the same industry. The estimating procedure simultaneously provides an indicator of growth of firms into the large business segment of the industry. Data available at the time of the study meant that the method could be applied only to the year 1977/8. Work is required on data for other years to test for change in demarcation size and stability of the indicator of growth into the large size segment.

4. Small business segments are industry specific and, as identified in the study, what is small is probably smaller than generally perceived.

5. If subsequent testing indicated that the findings in Volume II, Appendix A were accurate, they would indicate that significant Canadian participation and significant growth into the large business segment in 1977/8 was in the following SBFR Code Industries (3-digit level):

   i) Hotels, motels, campgrounds, etc.,
   ii) Food stores
   iii) Gasoline service stations
   iv) Miscellaneous service to business management
   v) Retail stores, N.E.S.
   vi) Motor vehicle repair shops, and
   vii) Hardware, household furniture and appliance stores.

   This would mean that Canadian entrepreneurial talent, in rising from the ranks of small business, is being channelled into a very narrow group of industries.

   A particular key segment of small business is the small consulting firm set up to provide, in effect, part-time management services to other small firms. Such firms, of course, are part of "miscellaneous service to business management," above.

6. Entrepreneurs themselves seek profitable growth, so such a goal may be thought of as a consensual national goal for small firms. Conversely, insofar as their objectives are concerned, small business collectively is a medium for pursuing government policy respecting growth. The survey of small business managers showed little desire on the part of entrepreneurs to trade off profitable growth for a comfortable life style.

   In 1977/8, the upper limit in sales for small business was estimated to be below $500,000 for 97% of the 198 SBFR code categories. Even if the upper limits were twice the levels shown, they probably would still be smaller than is generally perceived.

7. For start-up and growth small businesses, of course, have a basic need for equity captial. As we found in our survey of small business managers, however, such businesses are not particularly interested in outside sources of equity financing. This is a reflection of their desire to be independent.

8. This desire increases reliance upon internal sources of equity financing; it also makes term financing (including leasing) a more important source of long term financing for small business than perhaps has been generally acknowledged, or than might be readily perceived.

9. The dangers of mismatching the maturities of sources and uses of funds were not perceived as a serious problem by the small business managers themselves.

10. Term financing for small, new and unproven firms is more viable if there are active resale markets in the fixed assets which serve as security for the financing. Industries on the frontier of technological development may include firms which rely on equipment for which there is not yet an active resale market. Suppliers of such equipment may serve to a limited extent as a financing firm in such situations. However, this is a possible area for social purpose lending.

11. Financing needs are partly reflected in a firm's behaviour in seeking funds. Whether or not a firm is a manufacturer by itself, seems to have little general impact on the financial behaviour of firms in seeking funds.

12. More specifically, type of small business does not seem to affect where the business seeks financing. The only exceptions to this are:

    (a) Manufacturers are more likely to seek financing from financial corporations. This may be partly because manufacturers own equipment, but also because financial corporations have the expertise to make loans which other lenders may find too risky.

    (b) Smaller manufacturers without a full time financial manager are more likely than other firms to seek long term financing from FBDB.

13. The areas for growth of ancillary services provided by financial institutions appear to be data processing, cash flow planning and accounting packages with still more use being made of payroll facilities.

    Some NBFIs may have a significant opportunity to supply decision support systems to small business. Banks are proscribed by law from offering management advisory services.

14. One possible strategy to ease pressures for wage increases is to assist employees in making their wages go farther, and to improve the design of financial fringe benefits. Few small business managers appear interested in having a package of moderate-cost personal financial advisory services as a form of fringe benefit for their employees.

Objective 2:

to examine the current and potential availability of financing from non-bank financial institutions in relation to the needs of small business.

Conclusions

1. From the viewpoint of informed participants on its demand side, the supply side of the market in small business financing seems to be functioning reasonably well, at least. Only one in four respondents in the survey of small business managers said that they had not always been able to obtain as much or more financing than they applied for in the last three years. We cannot say what the optimal rate of rejection is, but it is greater than zero, of course. Moreover, most rejections of financing offers to small businesses appear to reflect selectivity on the part of the prospective borrower rather than frustration of his or her objectives.

2. Shopping for financing by small businesses is minimal in the short-term end of the market. The banking industry has a strong position on this source of financing because of its many ancillary services, and its advantages in taking security provided under section 178 of the Bank Act. Only shareholders loans are viewed as a secondary source of supply by a significant proportion of the financial managers interviewed. However, from the very few respondents who said they would approach them, credit unions, trust companies and financial corporations were viewed favourably.

3. Trust companies and financial corporations are apparently viewed as viable sources of supply of term financing (including leasing). Since only 48% of the small businesses surveyed would approach a bank first for such financing, it appears that there is room for NBFIs to compete.

4. The market in term financing for borrowers with annual sales below $25 million is very competitive. Loan officers of NFBIs perceive that they have many competitors and their offers are frequently rejected by borrowers who are shopping for better terms. Banks are seen as major competitors by most NBFIs.

5. While banks are major suppliers of term financing, it can be very misleading to view the scope and competitiveness of this market only in terms of what banks do and do not do. Managers of foreign bank affiliates who were interviewed expressed the feeling that Canadian chartered banks have relied too much on collateral and have not been innovative. Major NBFIs have field representatives calling regularly on present and potential customers seeking their business. There are

numerous small NBFIs who specialize in specific sub-markets. Based on expert knowledge about borrowers in a few industries and resale markets in a few types of fixed assets, they are able to compete where less informed lenders are not.

6. Although the market in term financing for small business is very competitive, interest rates in this market are necessarily high. Not only high administrative costs per dollar of loan and relatively high rates of default contribute to this condition. Provincial legislation to protect borrowers, and to protect their workers' unpaid claims in the event of failure of the business, necessarily raise the costs of small business financing particularly for the smallest loans.

7. The interest rate was unquestionably the most important concern of small business managers in deciding whether to turn down an offer of funds from lenders or lessors. Personal guarantees and collateral requirements were also found to be important.

8. The height and variability of interest rates in recent years have had an impact upon rate setting practice. In most loans, the interest rate is set on a floating rate basis. (In the survey of financing files, it was found that only about 15% of term loans were on a fixed rate basis.) In some of our loan officer interviews, it was indicated that sometimes borrowers prefer floating rates.

9. Two types of NBFIs are not covered in the study - life insurance companies and pension funds. These institutions have very long-term liabilities and from the standpoint of matching, at least, are in a position to supply long-term fixed rate financing to small business.

10. The true interest rate charged on term loans is often difficult to ascertain. Fees are frequently charged, sometimes because much work with the borrower is required to prepare a proposal. Where fees are not charged such work must be covered by the interest rate, assuming the loan is originated at par. Since borrowers may learn from the process of preparing a proposal, part of the interest rate, in a sense, could be said to cover costs of borrower learning. On the other hand, with vendor-financing of capital goods, the quoted interest rate may be low as part of the marketing strategy for the goods.

11. Thus, margins of rate over prime are not a reliable indicator of the range of risk classes covered by NBFI financing. As indicated by the survey of financing files, specified interest rates charged by participating NBFIs were mostly at or below bank prime +3.5%, plus fees in many cases. About 7% of the cases had higher rates, some with and some without fees. It appears that NBFIs do some relatively high risk lending.

12. The prospects are for greater NBFI involvement in small business financing. This is indicated in the survey of financial and trust company senior executives, and the survey of foreign bank affiliates. Increased participation is subject to some legislative constraints in the case of trust companies and credit unions. But the more important constraint in the short run is availability of staff. This applies to trust companies, credit unions, and foreign bank affiliates.

Objective 3

to analyze the impact of government programs and instruments upon small business financing in the light of current and potential activities of non-bank financial institutions and federal government objectives.

Conclusions

1. The appropriateness of government intervention in financial markets is viewed as an empirical question in this study. Findings from the study imply small business people are not incurring exorbitant costs in using the financial marketplace.

2. Government agencies appear to be under utilized by respondents in the Survey of Small Business Managers, and are viewed as bureaucratic and slow by many respondents in the senior executive and loan officer surveys.

3. FBDB is viewed as a viable source of financing by respondents to the Survey of Small Business Managers primarily in small firms without full-time financial managers.

4. Gaps in the supply of small business financing are largely in the eye of the beholder. As compared with firms without a full time financial manager, firms with a full time financial manager were found, on average

   - to be more successful, younger, faster growing, and have formal budgets,
   - to value the advice of their financial manager most highly for financial policymaking,
   - to have formal cost control systems to promote operational efficiency,
   - to say that inflation hurts them less,
   - to be less inclined to complain about interest rates, about which little can be done in a competitive market for funds,
   - to be more satisfied with the quality of service that

they receive from financial institutions, and
much less likely to complain about the institutions,

- to be more likely to approach financial corporations for financing; be less inclined to approach friends, relatives, shareholders, caisses or FBDB for financing,
- to be less inclined to want to sell out,
- to be less disposed to feel that governments should intervene in the financial market place to help firms like theirs, and more inclined to favour a "laissez-faire" approach.

5. That interest rates to small businesses may be materially higher than to large businesses is not prima facae evidence of gaps. Nor is the fact that term financing is not easily available for start-ups by unproven managers of businesses requiring atypical assets.

6. There were significant gaps caused by regulation before 1967 when chartered banks were not alowed to make non-residential mortgage loans and there was a ceiling of 6% on interest rates. Today, the Interest Act inhibits unincorporated mortgage borrowers from trading off some of their prepayment privileges after five years to obtain other more favourable terms. Federally registered trust companies may not make business loans secured by current assets. Financial corporations, trust companies, and credit unions are not authorized to take security on the basis provided for banks under section 178 of the Bank Act. Various provincial acts are designed to protect borrowers. These remaining gaps caused by regulation are small compared to those that existed before 1967.

7. This study has been unable to provide any evidence that government financing programs are really needed. Possibly the existence of such programs makes it easier for private suppliers of capital to reject low quality applications.

8. Government financing programs for small business do not address the primary source of small business financing problems. This study found substantial evidence that the problem in small business financing is insufficient financial management skills in the businesses themselves. Findings from the survey of small business managers have already been cited. From the surveys of NBFIs loan officers and financing files, it was found that the main causes for rejecting financing applications were poor business plans, poor bookkeeping practices, and lack of professional business competence on the part of the applicants. Managers of foreign bank affiliates stated that they believed Canadian small businesses need to be educated in finance and not be led to expect risky loans from financial institutions.

9. In a nutshell, the study supports the conclusions that the private market for finance is serving well-managed small businesses adequately, at least, and that government assistance to small businesses - if required at all - is more logically directed at concerns that are more fundamental to the managers than financing, such as marketing, production, personnel and cost control.

10. The study implies that if it is considered desirable to continue to assist small business in their financial affairs, subsidies may be more effective if applied to acquiring the relevant financial management expertise to ensure that the businesses are following good financial management policies and to maintain good relations with financial institutions. Possibly, non-competing small businesses could share the cost of a permanent financial manager, who would spend a day or so each week on the premises of each firm and be available on short notice to assist with important episodes of financing.

11. It appears that the chronology of policy development respecting small business began with the presumption that its major problem was financing. This goes back to the concept of the Macmillan gap which dates back to the 1930's and, indeed, in the field of agriculture, goes back further. There is a need to change this perception.

RECOMMENDATIONS

Objective 4:

to make recommendations pertaining to public policy issues in light of the above.

1. If governments are to provide programs to assist small business such business should be delineated on a less arbitrary basis than appears to be the practice at present. One possible approach that might be studied further is demonstrated in Volume II, Appendix A of this report.

2. Government programs designed to aid small business should take into account the fact that what is small in one industry may be large in another.

3. Instead of subsidizing financing for small business, some programs should be devised for assisting small business in problem areas that the businesses themselves hold to be of primary importance, if assistance is to be given to small business at all.

4. If financial measures that involve private financial institutions are to be used, they should be designed for all types of financial institutions that can be helpful in making them work, not just for a select few, e.g. NBFIs such as trust companies and term lenders might wish to make SBLA loans with interest rates fixed for several years.

5. A new institutional arrangement for providing financial management services for small business is required. We recommend that Government examine this requirement. One possible approach was described in objective 3, conclusion 10.

6. The Interest Act should be amended to permit unincorporated business mortgage borrowers to trade-off some of their prepayment privileges after five years for other more favourable terms.

7. The federal Trust Companies Act should be amended to permit trust companies to make loans to business secured by current assets, subject to appropriate limits in aggregate and for individual borrowers, with special lower limits if shares of the borrower's stock are held in estates, trust or agency funds.

8. The federal Co-operative Credit Associations Act should be amended to permit the Canadian Co-operative Credit Society and credit union centrals regulated by the Act to make loans to business secured by current assets, subject to appropriate limits in aggregate.

9. The basis of providing security that is granted to chartered banks under section 178 of the Bank Act should be made available to other lenders who wish to take current assets as security for loans.

10. Services of the kind provided by the Management Services component of FBDB should emphasize the development of small business managers' skills and the development of private, self supporting management services for small business. The problem of small business is not the supply of financing, but borrower education.

11. For the Financial Services component of FBDB, the Government has several options, especially if Recommendation 10 is adopted. One is to wind it down in its entirety. Another is to sell it at auction to the highest bidder, with no restriction upon potential buyers. These extremes would not recognize the possibility of a need to maintain services in smaller communities, which we have not studied. Also, there may be a need for specialized term lending to new high technology firms, and to other new firms that prove important in an industrial strategy. There may also be a need to provide equity capital to these firms. Finally, there is a need to consider the value of having an additional sizable privately owned Canadian term lender, especially when it would not have to be created from start.

With these considerations in mind, we recommend that a study be conducted of FBDB financial operations to determine what is best to do with them.

12. Analogously, we recommend that similar studies be made of provincial agencies akin to FBDB.

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