# Response to the Second Report of the House of Commons Standing Committee on Industry

## *Taking Care of Small Business*

# RESPONSE TO THE

# SECOND REPORT OF THE HOUSE OF COMMONS STANDING COMMITTEE ON INDUSTRY

# TAKING CARE OF SMALL BUSINESS

**March 1995**

Government of Canada Gouvernement du Canada

Canada

## RECOMMENDATION 1

The Committee proposes to continue monitoring small business' access to capital by calling one or more banks as witnesses every quarter, to review their performance in lending to small business.

**Response:**

The government fully supports the thrust of this recommendation. It should act as an effective means of encouraging the banks to maintain and enhance recent new products and services designed to facilitate greater access to capital for small businesses, and to improve relations with this community. The process of calling witnesses before the committee should also serve as an effective basis for monitoring progress in these areas.

## RECOMMENDATION 2

The Committee recommends that the Superintendent of Financial Institutions, together with Statistics Canada and the Bank of Canada, develop a new format for the collection, compilation and publication of statistics on bank lending to small business. These statistics should be based not only on the size and type of loan but also on the nature of the borrower, including gender, according to employment, sales, major sector of operations and by municipality. These statistics should be reported quarterly.

**Response:**

The government agrees that an improved statistical base on bank lending to small business is needed if progress in this area is to be monitored more effectively. As a result, the government has been working with the banks to develop more comprehensive data that will be published on a quarterly basis in the *Bank of Canada Review*. The new data will include information on the major forms of bank credit to small business. The government is concerned that certain types of data (such as lending by municipality) may be expensive to produce, difficult to interpret and be of limited usefulness. The government will continue to encourage the banks to refine and improve their small business lending data. It may be that some of the concerns the Committee expressed about lending data could be addressed in a more cost-effective manner through the use of surveys, rather than by the production of the additional on-going data series. Accordingly, the government will encourage private-sector organizations, which periodically conduct surveys generating supplementary data on small business lending, to continue to do so.

## RECOMMENDATION 3

The Committee recommends that the Joint Industry Canada Committee, in consultation with the Canadian Bankers Association, draft a code of conduct which, in plain language, would explain to customers the information that a loan applicant must disclose, a clear explanation of reasons for refusing a loan, a commitment to guide customers to alternative sources of financing and a commitment to provide an internal complaints-handling mechanism.

**Response:**

Following extensive consultations between the banks and the joint Industry-Finance task force, which was announced in the February, 1994 Budget, the major banks have developed a code of conduct governing their relations with small- and medium-sized enterprises (SMEs). The code includes commitments which respond fully to the above recommendation, specifying minimum standards the banks must incorporate in their individual codes; these codes are to be operational by March 31, 1995. To address expressed concerns over bank actions to withdraw credit on short notice, the code contains a provision requiring that a minimum 15 calendar days' notice be provided concerning bank actions to be taken because of a change in the credit relationship. This would include decisions to terminate/reduce outstanding lines of credit. The government will be monitoring the implementation of these codes to ensure that they are helpful to small businesses.

**RECOMMENDATION 4**

The Committee recommends that the chartered banks follow the example of the Toronto Dominion Bank in instituting a mediation process that can be invoked by small business borrowers from whom a bank decides to withdraw credit.

**Response:**

This is a very useful suggestion which the joint Industry-Finance task force encouraged the banks to study. The major banks have responded by developing an Alternative Dispute Resolution system. It contains provisions the banks will adhere to in setting up a process enabling their SME customers to have credit-related complaints reviewed by a neutral party in circumstances where internal bank complaint-handling procedures have failed to produce satisfactory results. The banks are committed to ensuring that this process for complaint resolution, which is to be operational by March 31, 1995, is accessible, confidential and cost-efficient.

**RECOMMENDATION 5**

The Committee recommends that the government establish an independent office of the Bank Ombudsman to investigate complaints of breach of duty or maladministration by the banks. As in the United Kingdom, the ombudsman should have the power to require banks to pay compensation to complainants for financial loss, inconvenience and stress.

**Response:**

The most common and serious type of friction relates to bank credit decisions, rather than administrative issues. As noted, the Alternative Dispute Resolution process is designed to deal with credit conflicts. On administrative issues, these are addressed in the code of conduct and the banks' enhanced internal complaint-handling procedures; there is an onus on the banks to demonstrate that these procedures are adequate. The government's view is that it would prefer to monitor the effectiveness of these measures, which have been and are being put in place to handle small business complaints, before taking additional steps. Should these measures prove to be ineffective, an ombudsman will be considered.

**RECOMMENDATION 6**

The Committee recommends that leasing should be encouraged and urges the government to ensure that tax measures and other programs do not discriminate against this method of financing.

**Response:**

The government recognizes the important role that financial institutions and leasing companies play in providing financing to small businesses -- either through loans to small businesses to purchase assets directly or through leases of equipment to be used by small businesses. In general, the government attempts to provide a neutral tax structure in terms of the lease or buy decision and this is the fundamental reason why the government made changes to the leasing rules a number of years ago. Although the government does not consider it necessary to make further changes at this time, it will continue to examine the tax system to ensure that it does not create significant biases between the various financing options.

**RECOMMENDATION 7**

The Committee recommends that the federal government establish a limited working capital guarantee for small- and medium-sized business exporters. Such a program should be self-financing and therefore priced in a manner commensurate with risk.

**Response:**

The government has taken significant action to provide greater access to working capital for small- and medium-sized exporters through the initiatives outlined below.

To make pre-shipment financing more accessible to SME exporters, the Canadian Commercial Corporation (CCC) has developed a Progress Payment Program. Through the program, an exporter will be able to draw on a special line of credit established by its principal banker for a particular export sale. This line of credit is approved after the CCC has assessed and agreed to support the deal. The CCC will monitor the contract and, as the work progresses, will approve progress payments based on the exporter's costs. On contract completion, the CCC will collect from the exporter's customer and use the proceeds to reimburse the financial institution. The program is available for transactions involving foreign governments as well as private-sector buyers.

To address post-shipment financing needs, the Export Development Corporation (EDC) is developing an innovative accounts receivable guarantee facility. Under this proposed program, the EDC would guarantee the payment of a portion of an exporter's foreign receivables to the exporter's bank. This will allow SME exporters to obtain operating lines of credit against their foreign accounts receivable, financing which is not normally available at present.

A closer partnership has also been achieved between the EDC and Canadian financial institutions in the provision of medium-term financing for exporters, particularly small businesses. In November 1994 the EDC and the banks reached agreement on an SME Risk-Sharing Framework, targeted at exporters with annual export sales of less than $10 million. The framework allows Canadian banks to provide medium-term buyer financing with a partial EDC guarantee, for certain types of transactions, in a large number of developing country markets. These developments will help improve the capacity of small businesses to export.

**RECOMMENDATION 8**

The Committee recommends that the government review the *Small Business Loans Act* in order to ensure that it continues to provide support to new small businesses to obtain fixed-asset financing.

Any changes to the Act should be based on the following principles:

- The Committee is concerned by the increasing cost of the program. It should, therefore, be reviewed by the government, considering its costs as well as benefits;
- The program should increase the availability of credit rather than allowing lenders to reduce the risk on loans that would have been made without the guarantee;
- The program should not give a preference to bank financing as opposed to financing from other private lenders.

**Response:**

A review of the Small Business Loans Program, including extensive consultations with key borrower and lender groups, was completed in late 1994. As a result of this review, the government will introduce a series of program changes, most notably the imposition of a new 1 ¼ percent annual fee on program lenders which may be passed on to borrowers through an increase in the maximum SBLA interest rate. These changes are designed to bring the program to full cost recovery for all new loans registered after March 31, 1995.

The program changes are consistent with the principles identified by the Committee. Moving to full cost recovery places the SBLA on a sustainable fiscal footing. Further, by eliminating the implicit subsidy previously inherent in the program, full cost recovery goes a long way to removing any incentive for lenders to include loans under the SBLA that they would have approved without the government guarantee. Full cost recovery also serves to level the playing field between bank financing under the SBLA and other types of private sector financing.

In summary, these changes are expected to eliminate the net fiscal cost to the government of new SBLA loans, while ensuring that the program continues to serve the needs of small businesses that otherwise would be unable to secure loan financing on commercial terms.

**RECOMMENDATION 9**

The Committee recommends that the mandate of the Federal Business Development Bank be confirmed and re-focussed as a complementary lender to small- and medium-sized businesses, and that it be authorized to use new financial instruments to fulfil its mandate.

**Response:**

The government is still reviewing changes to the FBDB's mandate. The FBDB will continue to fill the gaps by supplementing private-sector financing and complementing the work of other public-sector institutions and departments such as the federal regional agencies.

**RECOMMENDATION 10**

The Committee recommends that the Federal Business Development Bank consider changing its name to the Small Business Bank of Canada.

**Response:**

This recommendation will be considered in the context of proposed changes to the FBDB's legislation.

**RECOMMENDATION 11**

The Committee recommends that the *Trust and Loans Companies Act* be amended to remove the arbitrary capital requirements for the establishment of a trust company and the acquisition of full commercial lending powers. The Superintendent of Financial Institutions should instead establish guidelines setting out conditions for the establishment of new federally chartered trust companies and for the acquisition of full commercial lending powers. Institutions meeting these guidelines would be able to operate in Canada and make commercial loans, using the prudential portfolio approach.

**Response:**

The government has considered this recommendation carefully, but for prudential reasons, could not remove the current $10 million minimum capital requirement for establishment of a federally-regulated trust company. This provision, which applies to all federally-incorporated financial institutions, is intended to ensure a minimum commitment to the market by the owners of such institutions. Removing or making a meaningful reduction in this requirement would permit companies to operate in the deposit-taking market where the owners do not have an adequate stake in the solvency of the institution, and solvency concerns would be magnified to the extent that there is a focus being placed on the riskier spectrum of the lending market.

The government also has serious, prudential concerns with removing the $25 million capital threshold for full commercial lending powers, applicable to trust companies, and replacing it with guidelines. Federal trust and loan companies with less than $25 million in regulatory capital may currently place no more than 5 per cent of total assets in commercial loans. However, the Superintendent of Financial Institutions may permit larger companies to undertake either unlimited commercial lending, with no predetermined limits, or impose a limit in excess of 5 per cent of assets. Guidelines are already published outlining the criteria that are considered by regulatory officials in assessing whether or not to approve requests for commercial lending powers in excess of the 5 per cent limit.

**RECOMMENDATION 12**

The Committee recommends that the federal government and its agencies review their policies of cost recovery to ensure that they do not harm smaller trust companies and thus hinder competition.

**Response:**

The Office of the Superintendent is conducting a review of its policies regarding the basis on which it assesses the various classes of financial institutions for cost recovery of the regulatory services it performs. This review will focus on the need for fairness in the assessment levied on each type of financial institution.

**RECOMMENDATION 13**

The Committee recommends that, where the federal government delivers programs through financial institutions, all legislation, regulations, policy manuals and literature, should refer to financial institutions as defined in the *Bank Act*, excluding certain institutions only when there is reason to do so.

**Response:**

The government will implement this recommendation in instances where it is practical to do so. It is recognised that the definition of "financial institution" contained in the *Bank Act* would not be appropriate for use in all instances.

**RECOMMENDATION 14**

The Committee recommends that, at the next revision of the *Bank Act*, the government should consider creating a new category consisting of "Schedule III Banks"; these would have all the powers of existing banks but not be subject to the 10 per cent ownership limits that now apply to Schedule I banks.

**Response:**

A fundamental precept of Canadian banking policy is the view that widely-held domestic banks provide the best protection against undue influence by an owner of a bank which it controls. For this reason, Canada has widely-held Schedule I banks. The matter of ownership rules may, however, be the subject of further discussion in the context of the 1997 *Bank Act* review.

**RECOMMENDATION 15**

The Committee recommends that Schedule III banks should be subject to the same capital guidelines as those recommended above for trust companies thus ensuring that small institutions benefit from this new classification. Any trust activity would have to be offered through a trust company subsidiary.

**Response:**

As with Recommendation 14, the government has clear concerns with this proposal as it suggests an easing of prudential standards.

**RECOMMENDATION 16**

The Committee recommends that the federal government immediately remove from the *Bank Act* the limits on the size of foreign bank subsidiaries. Similarly, as the requirement for ministerial approval for new branches seems not to serve any policy purpose, the Committee recommends that this section of the *Bank Act* be deleted.

**Response:**

The government has already removed the asset size limitation on the foreign bank sector by way of recent legislation implementing Canada's financial services commitments under the General Agreement on Trade in Services (GATS). As for the second part of this recommendation, while the policy of requiring ministerial approval for new branches of foreign banks has not, in practice, created a problem for the foreign banks, this policy is nevertheless open for discussion in the context of current GATS negotiations on financial services, which are expected to be concluded by June 1995.

**RECOMMENDATION 17**

The Committee recommends that, at the next revision of the *Bank Act*, the government should consider allowing foreign banks to offer banking services in Canada through direct branching or via a Schedule II bank.

**Response:**

This recommendation raises prudential concerns as well as issues regarding Canada's negotiations on international trade in financial services. Additionally, as the foreign banks generally do not serve the small and medium-sized business market, removing the subsidiary requirement is unlikely to result in increased lending by this sector to the SME market.

**RECOMMENDATION 18**

The Committee therefore recommends the removal of the non-arm's length ownership restriction to allow owner/operators and other major shareholders to purchase RRSP-eligible equity securities in qualifying small, private companies. This measure would have to incorporate pre-determined limits on the amount of business income that could be distributed to shares held in the tax shelter.

**RECOMMENDATION 19**

The Committee recommends that non-arm's length shareholders, as defined in the current *Income Tax Act* regulations, be restricted to investing no more than 20% of their RRSPs in qualifying small, private companies.

**Responses (18 & 19):**

Generally, individuals are allowed to invest their RRSP funds in the shares of any private corporation provided that:

- the individual and the individual's family members deal at arm's length with the corporation; and
- either hold less than 10 per cent of the corporation's shares or have a total investment in the corporation of less than $25,000.

Expanding these rules to allow individuals to invest their RRSP funds in a non-arm's length business would entail significant revenue costs and compromise the primary objective of tax assistance for retirement savings.

First, substantial short-term revenue losses would result because individuals would be encouraged to make significantly higher contributions to RRSPs than they otherwise would.

In addition, if debt or equity investments in a non-arm's length business were eligible investments for an RRSP, individuals would be able to defer taxes on business income for a significant period of time by influencing the rate of return earned by the RRSP investments. For example, they could charge themselves a rate of interest that is well in excess of the market rate. Individuals investing in arm's length businesses do not have the same control.

Setting a limit on the portion of RRSP assets that can be invested in a non-arm's length business, as recommended by the Committee, would only limit the tax deferral advantages resulting from the fact that owner/operators can influence the rate of return on the investment in the RRSP.

**RECOMMENDATION 20**

The Committee recommends that the federal government inform provincial securities regulators about information disclosure requirements that can inhibit private small businesses from raising equity capital.

**Response:**

In an effort to minimise the impact of disclosure costs, several provinces have already made special provisions for small business equity issues. The federal government will, however, continue to urge provincial securities commissions to find ways to accommodate small business financing, consistent with their mandate of investor protection. More generally, the federal government is encouraging the provincial governments to explore options for improving the efficiency of securities regulation. Among these options is delegation of authority to the federal government to create a Canada

Securities Commission. This would serve to further reduce the cost of raising equity capital for all types of issuers, including small business.

**RECOMMENDATION 21**

In order to increase the supply of patient capital, the Committee recommends that the federal government reduce the capital gains tax rate on long-term investments in small, private businesses. The rate reduction should apply to investments held for at least five years. We urge the Department of Finance task force examining the $500,000 lifetime capital gains exemption (LCGE) to develop a proposal for implementing this recommendation.

**Response:**

As announced in the recent budget, the $500,000 lifetime capital gains exemption will be maintained in its current form. Consultations held by committees and the Department of Finance task force revealed that the exemption helps ensure that small businesses have adequate access to equity financing and provides retirement relief for small business owner-operators.

Canada already provides a very generous capital gains tax regime for investments in small businesses. Expanding this already generous system at a time when the government is closing tax loopholes and asking all Canadians to contribute to deficit reduction would be difficult to justify.

**RECOMMENDATION 22**

The Committee recommends the adoption of a new self-regulating mechanism for labour-sponsored venture capital corporations (LSVCCs). This mechanism would link the annual supply of federal tax credits to the labour-sponsored venture capital corporation's prior investment in small- and medium-sized Canadian businesses. The labour-sponsored venture capital coporations would also be subject to a strict annual audit. Where such a self-regulating mechanism exists under provincial legislation, the federal government would limit its review to ensuring that the labour-sponsored venture capital corporation's performance meets the objectives for which the federal tax credits were provided.

**Response:**

There are already requirements for labour-sponsored venture capital corporations to invest in small- and medium-sized enterprises (SMEs) which take effect 5 years after an LSVCC starts to raise funds. Failure to comply gives rise to penalties that can reach 40 per cent of the shortfall plus interest.

**RECOMMENDATION 23**

The Committee recommends that the Department of Finance make the necessary amendments to the *Income Tax Act* that would allow Working Ventures to invest in other venture capital funds, particularly community and expert funds, whose purpose is to invest in small- and medium-sized Canadian businesses. The Committee also believes that other private financial institutions, such as banks, trust companies, credit unions and caisses populaires, and pension funds should demonstrate more leadership in capitalizing community and expert pools of venture capital.

**Response:**

Allowing LSVCCs to invest in community and expert funds raises concerns because these funds would not necessarily be required by law to invest a portion of their capital in SMEs. As a result, complicated look-through rules would have to be developed to ensure that the capital supplied by LSVCCs to these funds is invested in SMEs as intended.

It is also important to note that LSVCCs can establish a working relationship with a community or expert fund, and invest directly in businesses based on the recommendations of the funds. This approach has recently been adopted by Working Ventures.

Banks are making some progress in expanding their role as suppliers of venture capital to small businesses through participation in provincial and private-sector investment funds.

**RECOMMENDATION 24**

The Committee recommends that the government establish a task force with representatives of the public and private sectors to study the operation of mutual guarantee cooperatives in order to determine the feasibility of establishing such cooperatives in Canada.

**Response:**

The government has agreed to provide support for a business networks pilot program, to be delivered through the Canadian Chamber of Commerce. This program is intended to foster a networking culture. As networking develops, individual networks may be interested in exploring the concept of mutual guarantee cooperatives.