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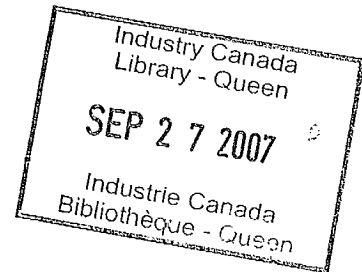


HIGHLIGHTS

of the

Small Business Loans Act (SBLA)

Stakeholder Consultations



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EXECUTIVE SUMMARY

A two phase consultation process on the Small Business Loan Act (SBLA) took place with stakeholders between December 1997 and May 1998 as part of a departmental program review. This report highlights some of the pertinent results from these consultations in which 27 lenders and associations were approached for comments and opinions on issues related to program expansion, cost recovery and administration.

PROGRAM EXPANSION

- The majority of stakeholders agreed that the SBLA continues to play a worthwhile and necessary role of increasing access to financing for small business in the financial marketplace.
- Only one of the six possible program expansion options elicited support by a majority of stakeholders - that of increasing **on-reserve financing**. Most did not believe the SBLA was the proper vehicle to include **knowledge based enterprises** (KBE's) and **working capital** loan options. Nor did they feel that opening up the program to **start-up enhancements** or the **voluntary sector** would be a good risk, stating that these proposals are outside the spirit of the program. **Capital leasing** elicited an array of diverging opinions. A majority disagreed with its inclusion with the determining factors focused around implementation and incrementality.
- Stakeholders affirmed that designated SBLA lenders should not include **publicly funded companies** but they were divided on whether Community Future Development Corporations (**CFDCs**) and Aboriginal Capital Corporations (**ACCs**) should be eligible as designated lenders.

COST RECOVERY

- Most stakeholders were satisfied with the current **administration fee level, financing / guarantee rate** and **maximum loan size**.
- Stakeholders agreed that despite the acknowledged high default rates on leasehold improvement loans, it would be difficult to **exclude** this type of loan from the SBLA.
- All stakeholders acknowledged the importance of asking for a **personal guarantee** but were divided on whether to increase it or maintain the status quo (i.e.: 25% of the amount of the loan).

ADMINISTRATION

- Stakeholders recommended that both the current **SBLA Regulations** and **aggregate lending ceiling structure** be revamped. Most recommend that the lending ceiling be based on the value of loans outstanding rather than the value of loans registered.
- All but one stakeholder was amenable to reverting to the **interim claims payment schedule** that had been in place prior to April 1, 1993.
- Stakeholders agreed that the government should have the authority to both approve and remove a **lender designation**, if circumstances warrant.
- A majority of stakeholders were also amenable to an **external compliance audit** as long as the rules were clear and the number of audits reasonable.
- Lenders stated that the great majority of loans made by their institutions were done with incrementality and with the same **due care** as uninsured loans.
- Several stakeholders would like SBL Administration to **collect more data** as well as **share more information**.
- **Program assessment and evaluation** suggestions include tighter regulations for improved monitoring, developing an evaluation framework and maintaining cost recovery.

WRAP-UP

- Stakeholder's primary concerns included the program's substantial administrative burden, the high cost of leasehold improvement defaults and the program's lack of flexibility due to a tightening of claims processing procedures.
- Some stakeholders felt that the SBLA program needs to be more tightly defined and administered particularly in the areas of security, verification and due diligence.

BACKGROUND

The Small Business Loans Act (SBLA) has been in force since 1961 as a loan loss-sharing program designed to increase the availability of loans for the establishment, expansion, modernization and improvement of small business enterprises. Upon favourable credit review of an SBLA application, designated lending institutions may offer term loans to a maximum of \$250,000 to businesses with less than \$5 million of sales per year for the purchase and improvement of premises and equipment and for the purchase of land.

The Government of Canada provides private sector lenders an 85% guarantee on loan losses. Over its 37 year history, the SBL program's loan repayment rate has averaged 94.4%, but for any year, loan repayment rates have varied from 96.2% to 91.4%. The program's fee structure is designed to cover cost recovery and produce a revenue stream that will offset loan losses over a 10-year period.

A comprehensive review is generally undertaken at the end of each SBLA lending period to ensure that it continues to meet the needs of small business and meets cost-recovery goals. The most recent lending period, (lending period 12) expired on March 31, 1998 and was extended by one year, until March 31, 1999 in order to complete this review.

CONSULTATION PROCESS

As part of the comprehensive review, consultations were carried out with borrowers and stakeholders. A separate report with results from focus groups with current and potential borrowers has been submitted to Industry Canada by Sage Research Corporation.

The stakeholder consultation process was conducted in two phases (see Appendix A). The first phase took place in December, 1997 when a consultation paper was issued to nine stakeholders who were asked to respond in writing to questions on issues pertaining to the provisions, operations and future direction of the SBLA. Fourteen written responses were received (additional responses were obtained from members of one association who chose to respond separately).

Phase II consisted of face-to-face interviews of approximately one hour each with lenders and interested associations between April 30 and May 8, 1998. An advance discussion paper was sent to 25 stakeholders. Of those invited, a total of 16 meetings and one telephone interview were conducted with 46 participants in Toronto, Montreal and Ottawa. Participants also had the option of submitting a written response to the second round consultation paper. Written comments were received from two national banks and two organizations.

CONSULTATION ISSUES

A total of 27 issues were commented upon by stakeholders in both the first and second round of consultations. Some issues were discussed in the written responses from stakeholders while others were discussed during face-to-face meetings. The following table categorizes these consultation issues in three broad categories: program expansion (9 issues), cost recovery (5 topics) and administrative practices (13 issues). This abridged report will highlight stakeholder viewpoints on key issues.

SBLA COMPREHENSIVE REVIEW ISSUES		
<i>PROGRAM EXPANSION</i>	<i>COST RECOVERY</i>	<i>ADMINISTRATION</i>
Capital Leasing	Administration Fee	Aggregate Lending Ceiling Structure
Role of the SBLA in the Financial Marketplace	Exclusions: - franchise financing - leasehold improvements - asset transfers - purchase of going concerns	Certification of Incrementality / Column Shifting
Knowledge-Based Enterprises (KBE's)	Financing/Guarantee Rate	Compliance Audit
Lender Designation: publicly funded; ACCs; CFDCs	Maximum Loan Size	Data Collection & Information Sharing
Maximum Sales Volume	Personal Guarantees	Due Care
On-Reserve Financing		Eligibility of Fees
Start-Up Enhancement		Fraud & Abuse
Voluntary Sector		Interim Claim Payments & Controlling Interest Costs
Working Capital Enhancement		Lender Designation: Application and Removal
		Program Assessment / Evaluation
		Regulations
		Security
		Transparency of Application Form

PROGRAM EXPANSION ISSUES

The majority of stakeholders stated that the SBLA program is worthwhile and beneficial to small business. In the words of one organization, "the SBLA is one of the most effective programs of its kind. According to our members, it is the best known, understood and used program of its type at the federal and provincial level."

The majority did not believe the SBLA was the proper vehicle for five of the six major program expansion possibilities: capital leasing, knowledge-based enterprises (KBE's), start-up enhancements, voluntary sector and working capital. There was uniform agreement to allow security to be taken on assets located on aboriginal reserves.

Capital Leasing

During both the first and second round of consultations, no other issue resulted in such a disparate range of views: five of the major banks and one association against, five in favour, three neutrals and one declined to discuss the issue. Those who disagreed with the inclusion of capital leasing cited implementation difficulties and a higher rate of default along with its impact on cost recovery, loan ceiling structure, higher fees and interest rate. Only two banks recommended a separate program be instituted.

Specific issues raised included:

- whether a demonstrated need or demand exists for this type of financing;
- the nature of the relationship between leasing companies and manufacturers;
- scrutiny of the lessors (unregulated market);
- the fact that the request originates from the leasing association and not small and medium sized enterprises; and
- the current popularity of leases in the marketplace without avail of the SBL program.

Knowledge-Based Enterprises (KBEs)

Most of the seven respondents felt that the SBLA might not be the appropriate vehicle to respond to what is essentially an equity financing problem. Three lenders support implementing a separate KBE pilot program outside of the SBLA. The only unequivocal affirmation came from an association who confirmed that a serious financing gap exists of amounts up to \$1 million since most venture capitalists only come into the project over and above this mark.

Lender Designation: Publicly Funded, ACCs, CFDCs

- Stakeholders were overwhelmingly against allowing publicly funded companies to become SBLA lenders stating that this was a form of 'double-dipping' and that the due diligence and lending procedures for publicly funded companies are different than those for the private sector.

- Responses were mixed on whether Community Future Development Corporations (CFDCs) and Aboriginal Capital Corporations (ACCs) should become lenders under the program. Five banks have declined to comment until the joint committee between the federal government and financial institutions issues its recommendations in Fall, 1998.

On-Reserve Financing

All 12 respondents supported the addition of on-reserve financing in the new legislation. The main issue is access to assets on reserve as security.

Start-Up Enhancement

Additional start-up enhancement is not needed according to the majority of the 12 respondents, although two lenders recommended instituting a separate program. Reasons include:

- the need for complex program and mandate restructuring;
- the need for increased program and personal guarantees;
- staying true to the program's fundamental principles;
- cost recovery issues; and
- similar, competing government programs (e.g.: Business Development Corporation - BDC) and equity investments by angel investors.

Voluntary Sector

Eleven of the twelve stakeholders who responded did not want the SBLA to be applied to the voluntary sector for the following reasons:

- it was outside the spirit of the program;
- voluntary organizations have a social role, not necessarily an economic one; and
- it would require a government guarantee of 75% - 100%, an equity increase to at least 20%, changes to the loan ceiling and unique credit analysis and security requirements.

Seven stakeholders including four banks said that while they disagreed with the concept, if the government wanted to go this route, they suggested creating a separate program that would include a 100% government guarantee.

Working Capital Enhancement

Most of the 13 respondents felt that while there is a need for working capital financing, the SBLA is not the proper vehicle. As working capital financing is a different product from asset based financing, it requires different security and servicing methods along with different monitoring and due diligence methods which increase the costs and risks associated with this type of lending.

Five stakeholders recommended either instituting a separate program or increasing the BDC loan maximum to \$250M. However, seven stakeholders argued that Export Development

Corporation (EDC), BDC and the Bureau fédéral de développement, région de Québec (BFDR(Q)) already have some form of working capital financing programs.

COST RECOVERY ISSUES

The SBLA has three program levers which the government has at its disposal to adjust the program towards achieving cost recovery: the registration administration fees, the financing and guarantee rates; and the maximum loan size. Stakeholders were solidly against changing any of these levers at the present time. Two stakeholders also recommended that Industry Canada make a "clear commitment to full cost recovery" rather than hedging on the goal of "moving towards cost recovery".

Exclusions

Stakeholders discussed whether leasehold improvement loans should be eliminated from the SBLA due to their high default rates and the program's commitment to cost recovery. Five lenders and one association felt that even though leasehold improvements were the most onerous to finance, it would be very difficult to eliminate them because most businesses have leasehold improvements. Some suggestions to offset the higher costs involved in these type of loans included increasing personal guarantees or increasing the fee structure.

Personal Guarantees

There were mixed responses from the eleven respondents as to the amount of personal guarantee that a lender may take. Most stakeholders acknowledged the need for personal guarantees since they demonstrate the borrower's commitment, motivation and good intentions for loan repayment. However, one association stated that the amount of personal guarantee is a careful balancing act to avoid discouraging small businesses from applying for an SBLA loan.

Two associations agreed with the status quo which allows but does not require lenders to take personal guarantees to a maximum of 25% of the value of the loan. Five lenders wanted an increase in the personal guarantee limit.

SBLA ADMINISTRATION ISSUES

Of the thirteen administration issues identified, the majority of stakeholders suggested and agreed to several recommendations to increase program efficiency such as:

- using a net loan balance that includes the deduction of loan repayments and defaulted loans as a lending ceiling structure;
- implementing an external audit procedure on loan claims and identifying lenders who have the highest regional claim rates and the highest losses;
- enabling the government to remove lenders as designated SBLA suppliers;

- making the regulations more user-friendly;
- reverting to an interim claim payment system in which interim claims are paid before full realization of security.

Certification of Incrementality

Lenders had mixed opinions about the proposal requiring lenders to declare on the SBLA registration whether the loan is incremental. A lender questioned the reliability of the information should the certification of incrementality proposal be approved.

Data Reporting / Collection & Information Sharing

Data Reporting and Collecting

- Banks strongly insisted that they did not want any new reporting requirements or additional administrative burdens.
- Lenders had divided opinions on the feasibility of gathering more information on **classes of loans** citing high cost as a factor.
- Suggestions were made on cost-effective reporting alternatives such as an on-line reporting system through electronic transfer or via the internet.
- To reduce risk, it was recommended that the program require small businesses to submit a detailed business plan.

Information Sharing Recommendations

- Four lenders asked that there be equal information access for all lenders as well as for Industry Canada. Two banks would be willing to share their information provided that they receive information on regional variations in lending and on their performance in the marketplace vis-a-vis their competitors.
- One bank suggested that rather than using job creation statistics as a measurement tool, Industry Canada should measure the growth rates and financing needs of small businesses that graduate out of SBLA-type financing.

Due Care

The Auditor General identified due care as a principle that lenders must adhere to in their disbursement of SBLA loans. Five lenders said there is no difference in the way they assess SBLA loans versus non-SBLA loans. Five lenders are currently or about to test a credit scoring system which would assess the borrower's risk quality and help reduce the bank's loss ratio.

Eight lenders felt that a great majority of the loans they make are incremental (i.e.: the loan would not be made if the SBLA program did not exist).

On the other hand, one organization comments on the "phenomenum (sic) of banks shifting lending that they should be doing outside the program onto the SBLA program - effectively moving risk off their books." It recommends monitoring incremental lending, including institutional analysis.

Fraud & Abuse

Stakeholders made many suggestions on one of the more prevalent areas of program abuse, that of multiple loans to related companies. While a few banks believe this type of abuse is not a widespread practice, one stakeholder suggested this problem could be alleviated if the Act were to include a definition of 'limited company'.

Other recommendations include:

- Impose sanctions where fraud or abuse has been proven;
- Impose caps of \$2-3M on aggregate SBLA loans;
- Ensure that the lender completes a corporate search at the company's branch in an effort to connect common shareholders;
- The SBL program should conduct claim spot checks. If abuse is found, the claim should be denied;
- Reinstigate requirement found on a previous SBLA loan application which asked potential borrowers if they had other SBLA loans outstanding or unpaid; and
- All information supplied by the borrower is verified by the lender.

Interim Claim Payments & Controlling Interest Costs

All but one of the eleven respondents agreed to an interim claim payment schedule that had been in place prior to April 1, 1993 which would allow for interim claim payments to be made before full realization of all security. Opinions on the appropriate claim period ranged from 120 days to two years from the current three year period.

To improve claims processing time, stakeholders suggested improving program flexibility (i.e.: less rigid claim adjudication), shortening the claim process and tightening administrative controls.

Recommendations to adjust program controls:

- Collection should include realization of security for loans delinquent over 90 days.
- Once loans are 120 days in default, interest recovery should be pegged at the national bank prime rate +2%.
- Government should not pay interest at the time of default but pay from the time the claim is received or 90 days after the formal claim is received.
- Introduce an annual review fee.
- Require regular reporting from borrower.
- Centralize all documents.
- Impose a \$ limit (\$1,000 or \$5,000) under which lenders making claims would not have to submit supporting invoices/cheques to confirm asset value and payment.

Program Assessment / Evaluation

Although not brought forward in the stakeholder consultation papers, several comments were received on this issue which was also highlighted by the Auditor General in his December 1997 report.

- One organization stressed that "government must reject the suggestion that the only way banks will loan to (small businesses is) under a credit guarantee scheme" and that as "useful as the SBLA program is, it should in no way be used by the banks as their response to the broad financing problems experienced by the majority of small firms in Canada."
- One stakeholder reiterated that gaps must be identified in the marketplace and that alternative policy and products be investigated in order for the program to remain viable.
- Stakeholders agreed with continuing to implement a program review every 5 years.

According to two stakeholders, Industry Canada must also do a better job at managing risk associated with the SBLA program by tracking the age of defaulting businesses, the sectors and regions where defaults are occurring and the purpose of the loans. By keeping careful watch on losses, the SBLA administration will be able to demonstrate that existing fees cover the possible losses.

Regulations

Five stakeholders were divided on whether the government should make program changes through legislation or regulation. One organization advocated a balanced approach recognizing that, in some cases, regulatory changes are necessary such as when the government needs to move quickly to correct unanticipated problems. In most other instances, the organization stated that fundamental structural changes should be made through legislation to ensure accountability and transparency under the program.

Two other stakeholders proposed that any revised legislation should include powers of the Minister to make informed, unilateral decisions using "just cause". These stakeholders also recommended that the revised legislation include penalties to be imposed for fraudulent offences. The range of sanctions could be defined in either legislation or the regulations whereas the criteria for "just cause" should be contained in the regulations.

Stakeholders also recommended rewriting the Regulations to make them more user-friendly and maintaining a minimum 90 day notice period for any changes.

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