

REPORT ON

**Small Business Loans Administration
Discussions with Financial Institutions**

Administration and Regulation of the
Canada Small Business Financing Program

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1. SUMMARY

The Small Business Loans Administration (SBL Administration) met with representatives of several financial institutions (FIs) during April and May 2004, as part of the five-year comprehensive review of the Canada Small Business Financing (CSBF) program. The discussions focused on the program's continued relevance, the extent to which its goals are being met, and whether changes are necessary. This document summarizes the discussions and input received during those meetings.

Findings

The central message from the FIs was that there is still a place for the CSBF program; however CSBF loans are burdensome and unprofitable. In its current form, the program does not make a good fit with highly automated organizations focussed on handling large volumes of conventional products.

FI input focused on three broad areas of concern:

- CSBF loan procedures consume too much time
- Loans made under the program are unprofitable
- The government guarantee is undermined by fear of claims rejection

FIs identified several opportunities for improvement:

Reduce regulatory burden: Allow FIs to use their normal practices to manage loan administration, including security documentation and recovery on default, to eliminate the need for duplicate sets of procedures.

Improve compensation to FIs: Allow FIs to charge the same fees on CSBF loans as for conventional loans. Remove the interest rate cap, so CSBF loans become a competitive product among FIs and the interest rate charged better reflects the credit risk involved.

Automate loan origination: Enable electronic completion of the registration form to reduce errors at origination and more closely mirror the way conventional loans are made.

Improve claims administration: Adopt a more flexible, less adversarial approach. Establish quality assurance procedures to ensure uniform service. Modify the regulations to make wider use of claims adjustments instead of rejections in cases of good faith administrative lapses on the part of FIs.

Make SBL Administration communications smoother and more consistent: Establish protocols for responding to inquiries. Publish and update a file of decisions and claim rulings that can be accessed and used as precedents by all FIs. Provide more information on program trends and statistics.

Outlook

All FIs expressed interest in continuing to offer government guaranteed loans as a means of extending their product offering to small businesses. They appear ready to consider any improvements that will better balance their interests with those of the government and small business clients.

2. BACKGROUND AND PROCESS

Industry Canada is currently undertaking a comprehensive review of the CSBF Program for the five-year period ending March 31, 2004. The comprehensive review report, including recommendations for any changes to the Program, must be tabled in Parliament by March 31, 2005.

The aim of the review is to determine:

- the program's continued relevance in meeting the financing needs of SMEs in evolving financial markets;
- the extent to which the program is meeting its goals of cost recovery and incrementality; and
- whether changes to the program are necessary.

The review process is being informed by various research studies commissioned and undertaken directly by Industry Canada. These include surveys, interviews, discussions and consultations focused on various aspects of the CSBF Program.

The SBL Administration conducted the discussions summarized in this document. The discussions focused on administrative and regulatory issues, rather than the overall parameters of the program. The Small Business Policy Branch of Industry Canada has conducted separate research on broader issues, including program parameters.

Industry Canada is committed to ongoing discussions with the FIs as the review process moves from this information-gathering phase to policy formulation.

A copy of this document has been circulated to participating financial institutions. Please see Appendix I for a list of participating FIs.

2.1 Discussion Objectives

The numbers of program loans have been declining annually since 1994. In 2002, Industry Canada commissioned qualitative research into reasons for the decline. The research results indicated lender concerns regarding:

- Administrative requirements of the program
- Profitability of program loans for lenders
- Claims processes
- Costs to borrowers

These discussions were aimed at exploring FI concerns more fully and identifying opportunities for improvements.

2.2 Discussion Format

A discussion document (*Canada Small Business Financing Act* Discussion Document, March 2004) was provided to all FIs in advance and was used to guide the discussions.

Topics were introduced and discussed in the following order:

ADMINISTRATIVE BURDEN

- Loan Registration Process and Requirements
 - (a) Due Diligence Requirements
 - (b) Proof of Purchase and Payment Requirements
- Loan Administration and Maintenance Requirements
 - (a) Administration Fee and Outstanding Loan Balance Reports
 - (b) Conversion and Prepayment Penalties
 - (c) Establishment, Substitution and Release of Security
- Claim Submission Process and Requirements
- Forms

PROFITABILITY

- Fees
- Interest Rate

GENERAL TRENDS IN LENDING PRACTICES

REPORTS

The discussions were held at the FIs' offices or by teleconference and ranged in length from two to eight hours. Participants represented all aspects of managing small business loans, were well prepared, open about their concerns, and generous with ideas for improvement. The following section includes a summary of the discussion findings.

NOTES:

1. Quotation marks indicate direct quotes from participants.
2. The heading "Changes recommended by FIs" identifies FIs' suggested improvements. Recommendations do not necessarily reflect a consensus among FIs, nor agreement by Industry Canada.
3. For a complete list of recommended changes see Section 4.

3. FINDINGS

3.1 Administrative Burden

3.1.1 Loan Registration Process and Requirements

General

CSBF loans allow FIs to fulfill their commitment to small business, without making loans beyond their risk thresholds. FIs want to be able to offer a product to every prospective borrower, even if the client ultimately finds the terms and conditions unsatisfactory.

“This is one of the most useful programs for our institution. It allows us to be a strong supporter of small businesses.”

However, recent changes in FI business processes have marginalized CSBF loans. As product offerings proliferate and decision-making becomes increasingly centralized and automated, account managers are losing the capacity and patience to work with paper-based systems and to cope with unfamiliar procedures for a niche product.

The same investments in systems that are enabling FIs to efficiently process growing volumes of conventional products have made their entire organizations less tolerant of administrative exceptions.

“The way we work with the government product is absolutely in conflict with the way we are moving.”

“Question is: Can we make SBLs part of our product suite instead of a poor cousin?”

“We overhauled our fulfillment processes for conventional loans, but had to build a separate system for SBLs.”

Examples of process improvements that affect CSBF loans:

Online ‘smart’ forms

Applications for FIs’ products (except for CSBF loans) are completed online by programs that check all fields for format and auto-populate fields for existing customers. As a result, account managers are less familiar with paper forms, which may explain the error rates on CSBF loan registrations. Clients have also come to expect forms to auto-populate and become frustrated when asked to repeat previously collected information for a CSBF loan application, or to provide information required for statistical purposes only.

New decision-making strategies

FIs now rely mainly on past behaviour of borrowers and guarantors to make decisions on business loans under \$50K. Because an individual's credit history is readily available online, it provides a more accessible measure of propensity to repay than does business performance or asset value. Some FIs require only limited business information for loans under a threshold. This reliance on personal data, rather than business records, has made conventional products faster and cheaper to process, especially for low dollar amounts.

Streamlined decision-making

Most FIs have automated credit scoring in the past ten years, and some have moved to real time adjudication. Some FIs can provide a decision on loans up to \$25K within one day. Larger conventional loan approval often takes less than a week. This speed is attractive to the borrower, compared with the two- to three-week turn around for CSBF loans.

More sophisticated risk assessment

Computerized decision support has also enabled FIs to develop more uniform rules for assessing risk in the small business market. One result may be a smaller "grey area" where front line managers could opt to reduce risk by offering a CSBF loan.

Automated loan monitoring

FIs have automated loan monitoring, reducing conventional loan administration costs and widening the profitability gap between conventional and CSBF loans. FIs charge fees to monitor conventional loans; these fees are not allowed under the CSBFA.

Change recommended by FIs:

Develop online "smart" forms for CSBF loans to allow FIs to complete the application and registration processes electronically, as they would for conventional products.

a) Due Diligence Requirements

DISCUSSIONS POINTS

1. Are the regulatory requirements compatible with those of your institution?
If not, what are the main differences?
2. Do you believe the due diligence requirement effectively reduces risk?
3. Is there a need for clarity in the Regulations or in the Guidelines over what constitutes due diligence? If so, what needs to be clarified?

The regulations allow FIs to use their conventional due diligence procedures to determine the creditworthiness of a program loan applicant, with additional checks to ensure the applicant qualifies under the program.

In practice, most FIs first use manual or automated credit scoring to determine whether a candidate qualifies for a conventional loan. Only after failing to qualify for a conventional loan, is an applicant considered for a CSBF loan. FIs stated that CSBF loans are offered only if the deal appears economically sound. Some FIs include CSBF loans in larger financing packages that require additional security.

Most common situations where CSBF loan applicants are ineligible for conventional financing:

- Businesses under two years old
- Loans secured by fast-depreciating or low recovery-value assets, such as leasehold improvements and used and/or specialized equipment
- Loans to risky industries, such as hospitality and trucking
- High-loan-to-net worth situations, such as some major equipment purchases and new location expansions
- Clients who cannot or prefer not to provide a 100 percent personal guarantee

“There are really two buckets [of CSBF loan candidates]—start-ups, and established businesses wanting to expand or open another location with limited liability.”

“As a general rule, [CSBF candidates are] deals that make sense but are in higher than usual risk areas—leasehold improvements, start-ups, certain industries—are where we use the government guarantee.”

“If the amount is under \$250K and the security is lacking, then we look to the CSBFA.”

FIs did not report concerns for due diligence, likely because their processes in this area satisfy current program requirements.

Changes recommended by FIs: None

b) Proof of Purchase and Payment Requirements

DISCUSSION POINTS

1. Are the requirements for proof of purchase and payment compatible with those of your institution? If not, what are the main differences?
2. Can you suggest alternatives to the requirement to substantiate the cost of the asset by providing photocopies of the invoice or contracts and proof of payment?

NOTE: In every meeting, discussions around this topic broadened to include other program requirements related to taking security.

The regulations in this area, particularly with reference to leasehold improvements, are not compatible with FI practices. For conventional loans, FIs use common sense and the “know your client rule” to determine how much documentation to require. They consider loan size, type of assets being financed, geography and client history. CSBF regulations provide no latitude to make these judgement calls.

This is a significant area of concern for FIs, because of their experience with claim adjustments and rejections caused by documentation flaws. For CSBF loans, the FIs admitted their focus shifts from the underlying assets to perfecting the documentation. Training staff and borrowers in the documentation requirements of the program is burdensome.

“On a conventional loan the Personal Property Security Act (PPSA) registration is the security. On a CSBF loan, security is the documentation.”

“Proof of payment documentation for CSBF loans is much more onerous than with conventional products—some account managers avoid them altogether for this reason.”

“In assessing risk on a conventional loan, proof is not as relevant as what the asset is worth. On a CSBF loan, the bank needs to be very fussy about the *form* of proof of payment.”

“IC should rely on undertakings from the bank. Aren’t we your agents for due diligence?”

FIs believe the proof of payment requirements need to be made more flexible, especially in the case of leasehold improvements (see below). They also provided evidence of pushback:

- Some account managers avoid making CSBF loans because of the burden caused by proof of payment requirements.
- FIs are reluctant to accept transfers of CSBF loans because of concerns that a missing invoice or proof of payment might jeopardize a future claim.
- Borrowers have complained about the paperwork burden.

Leasehold Improvements

Applying the program regulations to leasehold improvement loans is frustrating for both FIs and their clients. Several FIs described this to be the program's single biggest irritant.

Proof of purchase and payment requirements are especially problematic in the case of leasehold improvements. On many projects, clients economize by acting as general contractor, and they shop for fixtures and materials using personal credit cards or Interac. This results in many requests for small disbursements, each of which takes time to administer. Regulations prohibit charging fees for these disbursements. Also, some FIs interpret proof of payment for credit card purchases to include a copy of the paid card statement, raising privacy issues.

While the resulting documentation costs time and creates client frustration, FIs believe it has no security value, since leasehold improvements are usually worth nothing on recovery.

"With leasehold improvements, the proof of payment requirement is just a make-work exercise. It adds no value to the transaction."

"What's the point of documenting all this paperwork, when the [leasehold improvement] has no value?"

"Customers of every type are very unhappy with CSBFA documentation requirements. Leasehold improvements are the worst."

"The requirement for invoices is not consistent with the kind of customer experience we want to have."

"We try to establish enough trust with clients that we know they're going to do what they say."

"For a CSBF loan, the customer has to bring in every invoice, every receipt, every proof of payment, and we have to fund against each one."

"It's hard to educate the customer as to how he/she needs to behave to fit the program."

Other leasehold improvement concerns:

- Landlord waivers are hard to obtain and seldom improve recovery.
- The requirement for a first mortgage when the borrower and landlord are related causes resistance, especially if the loan amount is small.

Changes recommended by FIs:

1. Create thresholds for documentation related to loan size, to align more closely with FI risk management procedures on conventional loans.
2. Require documentation up to a percentage of loan value.

3. Accept an undertaking from the FI that loan proceeds were spent for purpose stated.
4. Accept a lawyer's trust that proceeds paid into a trust account were used for the purpose specified.
5. Drop the requirement for landlord waivers. These are hard to obtain and add little value.
6. Allow alternate security instead of a first mortgage when building owner and borrower are related.

Appraisals

Missing or unacceptable appraisals are the largest single cause of claim rejections, yet FIs believe that accurate independent appraisals are impossible or impractical in certain situations. This is especially true in remote areas, and in the case of specialized assets and going concerns. Locally based FIs, such as credit unions, have the expertise to do their own appraisals.

"Since appraisals nearly always come back at the cost, why do them?"

"In many cases, the skill set needed to do a proper appraisal doesn't exist."

As a separate issue, requiring an appraisal prior to loan approval is often not always practical.

Changes recommended by FIs:

1. Require appraisals for non-arm's length transactions, but not going concerns.
2. Allow FIs more flexibility in deciding whether and how to obtain appraisals.

3.1.2 Loan Administration and Maintenance Requirements

NOTE: In most meetings, the discussions broadened to include other aspects of loan administration. See Other Loan Administration Concerns below.

(a) Administration Fee and Outstanding Balance Reports

DISCUSSION POINTS

1. For the annual Administration Fee Report, are the monthly outstanding loan balance amounts available:
 - On a loan-by-loan basis?
 - With the CSBF Program registration number?
2. How would your institution regard a move to create one report satisfying the requirements of both the Administration Fee Report and Outstanding Loan Balance Report?

The SBL Administration requires FIs to provide an Outstanding Loan Balance Report on a loan-by-loan basis as at March 31 of each year. Because most FIs do not include the CSBF loan number, the SBL Administration and FIs have experienced difficulty reconciling.

FIs are also required to provide an annual Administration Fee Report. Those with 50 or more loans must submit an external auditor's report certifying that the amount remitted is correct in accordance with the requirements of the CSBFA.

Several FIs commented on the burden created by the Administration Fee Report and the need for an auditor's certificate. Most FIs have no room for the CSBF loan number in their computerized loans systems, and cannot justify adding a field.

"For the work the detailed report creates, we can't see the value it creates."

"We have no room in our system for the CSBF registration number."

"We can't afford to invest hundreds of thousands of dollars on automated solutions where there is no payback."

"Having an auditor come every year to confirm we are still doing what we did last year is just a cost for us."

"The annual Administration Fee Report is a highly time-consuming exercise."

Changes recommended by FIs:

1. Allow FIs to submit quarterly figures in Excel format.
2. IC could validate transit number and loan number at registration using FI-provided formats to reduce reconciliation errors.

3. Two FIs that track the CSBF number offered to provide more detailed reports to SBL Administration on a month-by-month basis, in exchange for dropping the requirement for an auditor's certificate.

(b) Conversion and Prepayment Penalties

DISCUSSION POINTS

1. Are these requirements compatible with those of your institution? If not, what are the main differences?
2. Under what other circumstances does your institution charge a penalty on a conventional loan? How are these penalties calculated?
3. What types of interest rate conversions are requested on conventional loans? How are penalties, if any, calculated?
4. What are the common types of prepayments requested on conventional loans? How are penalties, if any, calculated?
5. Are there other conventional loan situations where penalties are charged?

Conversion and prepayment penalties in the regulations generally coincide with the FIs' internal practices; however, the calculation methods differ. FIs reported that CSBF loan clients seldom request conversions or prepayments.

Some FIs noted that the wording of the rate differential provision (10.4 b) is confusing. One reported three instances in the past three years where a client's lawyer demanded clarification of the provision. The FI involved was unable to respond satisfactorily, and believes the wording of (10.4 b) is faulty. According to the FI involved, SBL Administration did not satisfactorily respond to requests for clarification.

All FIs would prefer to have this area deregulated.

Change recommended by FIs:

Deregulate conversion and prepayment penalties to allow FIs to use normal banking practices.

(c) Establishment, Substitution and Release of Security

DISCUSSION POINTS

1. Are these provisions in line with the procedures in your institution? If not, what are the main differences?
2. Can you comment on how any of these sections could be changed to reduce administrative burden? How would these changes affect risk?

FIs identified two areas where the regulations differ from their practices:

- Postponement of a second or third charge requires the total charge ahead to be no greater than before. This is a problem when an owner wishes to take equity out of real property that has appreciated.
- Requirement that a loan be paid down 50 percent before substitution of guarantees is not always reasonable, for example where the business is changing ownership.

In each of the above situations, the FIs involved would base their decision on the individual circumstances. FIs would prefer to follow their standard procedures and common sense. They do not believe their normal procedures would add risk.

Change recommended by FIs:

Deregulate substitution and release of security provisions to allow FIs to use normal banking practices.

Other Loan Administration Concerns

Generally, FIs believe the regulations micro-manage CSBFA loan administration to no benefit. Even seldom-used provisions are problematic, because an FI must spend time checking, first internally then with SBL Administration.

FIs follow every regulation with great care, even exceeding requirements, to avoid jeopardizing a future claim. Fear of claims rejections (described later) prompts FIs to err on the side of caution in every situation, creating an unintended layer of burden.

“Every time you add a requirement that’s different from what we usually do, you add administrative burden.”

“There’s a need to make the program more flexible in every area.”

Other concerns raised:

- SBL Administration needs to improve communications with FIs.
- In the regulations, default deals only with CSBF loan conditions. Consider a cross-default provision, so an FI can move against a CSBF loan if the borrower is in default on other loans.
- Amortization rate of 10 years is too short for some real estate loans. In other situations it is too long, but customers know about it and demand a 10-year amortization.

Changes recommended by FIs:

1. Deregulate loan administration to allow FIs to use normal banking practices.
2. Publish regular bulletins reporting current rulings.
3. Enter into partner agreements for turnaround time on inquiries (within 24 hours).
4. Put all answers in writing so they can be attached to the relevant file.
5. Maintain a current list of FAQs online that can be used as precedents.
6. Create an interactive link on the SBL Administration website for inquiries.
7. Institute a telephone hotline, accessible to front line people.
8. Include a cross-default provision in the regulations, so FIs can demand payment of a CSBF loan if other loans to the same borrower are in default.
9. Do not stipulate a loan term. Instead stipulate just that the government guarantee expires in ten years.

3.1.3 Claims Submission Process and Requirements

DISCUSSION POINTS

1. Are these requirements compatible with your institution's processes and approaches? If not, what are the main differences?
2. What are the main irritants related to these provisions?
3. What measures would you suggest to improve claims processing under the CSBF Program?
4. Adjustment and rejection of claims.

FIs vary in their standard approaches to loss recovery. Generally, larger FIs reported a greater willingness to abandon hard-to-recover assets on conventional loans and to pursue personal guarantees through collection agencies than did smaller FIs. Not surprisingly, therefore, these FIs found their procedures less compatible with the expectations of SBLA Claims Administration.

So while some FIs commented:

"On a conventional loan, we can come to a decision that the business assets are unrecoverable and go after the guarantee. Under CSBFA, we need to get a receiver's certificate under CCRA, appraisals and so forth. All this time, I need to continue to pay the fee to Industry Canada."

"On a personal guarantee, we can quickly see if the guarantor has any assets. On an \$80K loan, the guarantee is only worth \$20K. We'd send this to a collection agency."

—others said:

"Your rules make no difference to my life. I get back every dollar I can."

"The prospect of having to go through a claim is not a barrier to us."

Irritants reported by FIs fell into two broad categories:

- (i) Inflexibility, and
- (ii) Inconsistency

(i) Inflexibility

FIs reported a lack of flexibility in claims processing. Despite CSBF program statistics showing fewer rejected claims than for loans under the SBLA, there is a common perception that even a minor defect will result in rejection of a claim. This fear bogs down loan approval and administration at every stage, reducing profitability and customer satisfaction.

Several FIs used the word "fear" in describing the claims process. One provided three examples of claims rejections for what it considered administrative errors. It believed lesser penalties should have been imposed.

Some FIs screen their claims documentation and do not submit imperfect claims. Others reported taking measures beyond those for conventional loans to avoid claims rejections and/or delays.

Examples:

- Obtaining copies of the lawyer's detailed disbursement accounts when loan proceeds are paid into a trust account.
- Obtaining credit card statements showing payment for asset purchases made by credit card.
- Not taking general security agreements (GSAs) on CSBF loans, to avoid being forced to wind up a business before collecting the guarantee. The FI would take the GSA if it were allowed discretion on whether to realize on it.
- Closing out a CSBF loan that has become non-current and re-booking a new loan, complete with new security documentation, creating burden for the FI and the customer. Conventional loan procedure is to temporarily de-market a non-current loan.

"We find IC very, very, very strictly interpreting the regulations, and on minor technicalities whole claims are rejected."

"The account manager has a fear of doing all this extra work, and then, if there's a default, there's a real danger the claim will be reduced or rejected."

"[Account managers say:] Oh, that's the program where, if I do one thing wrong, I can't get my claim honoured. I don't want to live with that."

"It's not: How well did the bank do in trying to collect the claims? It's: What can I do to find a place where there's a breach?"

"Our people who work with CMHC get a much more cooperative approach."

(ii) Inconsistency

FIs provided conflicting reports of their relationship with claims administration. Some reported an improvement only after visiting Ottawa.

So while some said:

"You seem to be at the mercy of the person you get."

"A while back, the back and forth with IC was very onerous. Then it subsided. Now there are signs it seems to be back."

—others said:

"IC people offer the benefit of the doubt. There is great fairness in the process."

"We got together with the claims people in Ottawa and the claims service improved dramatically."

Changes recommended by FIs:

1. Build more flexibility into the claims process and/or the regulatory requirements.
2. Establish a quality assurance process for SBL Administration to ensure uniform service.
3. Streamline the interim claims process to help FIs get defaulted loans off their books.

3.1.4 Forms

DISCUSSION POINTS

1. What aspects of these forms does your institution find burdensome?
2. How specifically, could the forms be made simpler and more user-friendly?

FIs were generally satisfied with the forms, except for the recommendations below.

Changes recommended by FIs:

1. Develop online "smart" forms for the program, accessible via the IC website.
2. Use a simpler form for final claims after an interim claim has been filed.

3.2 Profitability

All FIs complained that program loans are unprofitable. However, they would not say that a richer program would improve incrementality without parameter changes, for example to include working capital loans or increase the pool of eligible companies.

Some FIs actively discourage CSBF loans by excluding them from their incentive systems. All FIs reported that account managers are well aware that CSBF loans are unprofitable, carry added burden and have a reputation for claims rejection.

So, while all FIs will offer CSBF loans where conditions warrant, several agree that loan officers avoid them. At one FI, the credit centre will recommend alternate products when a CSBF loan application is submitted. It is unknown how much these individual actions reduce uptake.

“The front line has no incentive to make a BIL. It’s lots of work, with no impact on the bottom line.”

“It’s more expensive for us to offer the [government guaranteed] product, yet we can’t recover the costs.”

“We increased branch compensation by \$150 on CSBF loans to compensate for the increased burden.”

“On higher risk loans, we need to find a way to recover more of our administrative and recovery costs, or charge higher rates, which we would share with Industry Canada.”

“We can make more money if we do it ourselves, for two reasons. One is the rate. The other is time—BILs take three or four times as long as a conventional loan.”

3.2.1 Fees

DISCUSSION POINTS

1. For conventional loans, what types and amount of fees does your institution charge for approving and administering loans, and for realizing on security?
2. Which of these fees would be most attractive to your institution if the CSBF Program allowed the lender to charge fees to borrowers?

Set up fees for conventional loans range from under \$100 at \$100K to \$200 at \$250K. FIs also charge annual loan maintenance fees and security preparation fees. Some FIs charge no set up fee for loans up to \$100K. Borrower resistance to conventional loan fees varies. The much higher CSBFA registration fee creates resistance from some borrowers.

FIs want to be able to charge the same range of fees as for conventional products. Some FIs recommended lower CSBF fees for repeat borrowers and mature companies, to encourage less risky businesses to use the program and to provide room for FI fees. Most FIs did not see fee income alone providing the compensation needed to make CSBF loans profitable. There was not a consensus on borrower attitudes towards fees.

"Fees are a problem for the sophisticated client."

"Currently the rates are competitive, but the set-up (registration) fee is a sticking point."

"Businesses will pay the going interest rate, but they don't like paying [application] fees."

"Time has come to change the 'no fees' rule."

3.2.2 Interest Rate

DISCUSSION POINTS

1. Should the rate cap be changed?
2. What range of interest rates does your institution charge on conventional loans under \$250,000? What factors determine these rates?
3. Would your institution's profitability concerns be better addressed by a rate cap increase, or by allowing fees to be charged on CSBF loans?
4. Is the fixed rate calculation, based on the residential mortgage rate, still relevant?

FIs believe higher interest rates are needed to provide fair compensation. Most FIs believe the rate cap should be removed so rates can be risk-adjusted.

Interest rates on comparable conventional loans range from 2 to 5 percent over prime. Most are at prime plus 3 or 3.5 percent. The rate is determined in each case by the FI's perception of risk and the borrower's willingness to pay.

FIs believe the residential mortgage rate is no longer meaningful, since it is routinely discounted. In practice most loans are at floating rates.

"One point seven five is not sufficient on longer amortization loans."

"I don't think you'd have a difficult time raising rates."

"Remove the cap and let the market determine the rate."

"Let's face it, some of these businesses are higher risk. Why not risk-adjust the premium?"

"There's not a huge interest rate sensitivity on the part of the borrower—especially for leasehold improvements."

"Why this one price fits all? I mean, restaurants and bars? Prime plus three is a great deal for those guys. We have bars and restaurants on our books, but we charge for managing that extra risk."

Other profitability issues

Other aspects of the program raised as profitability issues were:

- (i) Burden, and
- (ii) Incentives for low claims

(i) Burden

For all the reasons identified in Section 3.1, CSBF loans cost more to administer than conventional loans. Small loans are especially unprofitable, which may in part explain the trend to larger average CSBF loans.

Centralizing loans administration over the past several years has enabled FIs to track internal costs more accurately. FIs indicated that reduced burden would provide as much incentive to program use as increased revenue.

“The biggest issue is the amount of time needed to do a loan under this program.”

“Recovery cost is a big disincentive to product use. External costs are recoverable, but internal costs are still real.”

“It costs us \$500 a year to administer a [conventional] business loan. A \$25K loan loses money, a \$100K loan may break even at 3-3.5 percent over cost.”

“The challenge is to balance administrative complexity with the opportunity to improve cost recovery for both the FIs and IC.”

(ii) Incentives for low claims

Some FIs believe their claims experiences are among the lowest of all FIs and feel they deserve compensation, either financial or in the form of reduced oversight.

“If you’re getting sixty percent of your write-offs from one or two FIs, the rest of us are being penalized.”

Changes recommended by FIs:

1. Allow FIs to charge their usual fees on CSBF loans.
2. Remove the interest rate cap to allow tiered pricing and make CSBF loans a competitive product among FIs.
3. Charge lower registration and annual administration fees to lower risk borrowers. To identify candidates, use loss history and leverage the FIs scoring systems.
4. Offer lower fees to repeat borrowers and mature companies.
5. Deregulate loan administration.
6. Remove the cap on Minister’s liability.
7. Reward FIs with low loss experience.

3.3 General Trends in Lending Practices

DISCUSSION POINTS

1. What types of new lending products have made it easier for SMEs to access credit, especially for loans under \$250,000? What are their advantages and disadvantages over CSBF Program loans?
2. Have changes in credit scoring for SME lending impacted on your institution's use of CSBF Program loans? If so, how?
3. Has the demand for conventional loans to SMEs decreased?
4. How has electronic commerce affected your institution's use of the CSBF Program?

All FIs are experiencing growing demand for small business loans (one said applications for loans under \$100K were growing at 20 percent per annum) and believe the SME market is important to their own future growth. They are striving to provide the best possible customer experience to SMEs as efficiently as possible, using innovations such as online origination and automated scoring systems and loan monitoring.

All said that speed is most important to small business clients. One provided the following hierarchy of motivators for SME loan-seekers:

- Getting the money ASAP
- Quality of service
- Fees
- Interest rate

Some FIs have responded to the demand for speed by moving to real time adjudication and one-day turnaround on loans under certain size thresholds. All said conventional loan decisions are made faster and with less documentation than CSBF loans require.

More convenient alternatives to traditional business lending have also become popular. Many business owners finance their businesses through personal credit and other unconventional sources. Many high quality assets are now vendor-financed. FIs have made home equity loans easier to obtain, and these are being widely used to finance businesses.

FIs believe the CSBF program needs to join the trend to simpler, faster, easier.

"Small business owners want the money *now*."

"Customer will choose the faster process, so the question is: Can we achieve this (one day) on BILs?"

"People want fast turnaround. They don't want 15 days. With this program, a \$50K decision can take 3-4 weeks."

"Small business people don't want to spend time with their banker."

"To make CSBF loans a mainstream retail product, the answer is: faster, easier, simpler to deliver."

"Fundamentally, we should be trying to treat CSBF loans like standard products."

"Program needs to change to meet the changes in the marketplace. It does not reflect needs as well as it did 20 years ago."

"In an ideal world we'd use all the same processes for due diligence, taking security, then print out a separate form for an SBL containing the 25 percent guarantee and any other differences. Customer would sign it and go on his way."

A traditional advantage of the CSBF program has been the limited personal guarantee. But FIs were divided on the importance of this feature.

"The vast majority of clients do not have a problem pledging their personal assets. For most clients, it's just not a big issue. When they do provide personal security, we have more flexibility. We give them back value for taking the security."

"Most customers don't have the assets to support a 25 percent guarantee, so their willingness to put up a 100 percent guarantee doesn't matter."

"A high percentage of business owners with strong profiles want limited liability, especially at higher amounts."

Unmet Needs of Small Business

Companies that are successful quickly outgrow the program. One FI reported that operating capital and equity were the biggest unmet needs for small businesses. These do not fit the investment criteria for FIs participating in the CSBF program.

"If there's a need in the market, it's for start-up financing at the low end. Start-up businesses need \$25K in operating funds. Would the government look at opening up this area?"

Changes recommended by FIs:

1. Find ways to harmonize the program with FI administrative systems to improve speed of decision-making.
2. Increase the cap on loan size to \$500K or \$1M for real property.
3. Consider working capital loans.
4. Consider a 'patient capital' component (equity).

3.4 Reports

DISCUSSION POINTS

1. How useful are the current reports? Do you have suggestions for improvements?
2. What other information would be useful in managing your portfolio? For example, loans data, claims data, contingent liability report, etc.
3. Where new reports are required, what should their contents and frequency be?

The SBL Administration provides two reports on CSBF Program activities to all lenders:

- Annual Report on the program
- Quarterly report on the number and value of loans made by individual financial institutions

Lenders periodically request additional reports, for example:

- Status of the Minister's liability for their institution
- Claims data on their CSBF loan portfolios.

FIs requested regular reports on claims reductions and rejections and the balance in the Minister's contingent liability account. Several offered to reply later.

Changes recommended by FIs:

1. Report on loans and claims for each FI. Format should allow the FI to compare its own experience with results for all FIs.
2. Provide to each FI a report on the balance in the Minister's contingent liability account, by loan period.

4. LIST OF CHANGES RECOMMENDED BY FIs

The following is a list of the FI recommendations contained in this report:

ADMINISTRATIVE BURDEN

Loan Registration Process and Requirements

1. Develop online "smart" forms for CSBF loans to allow FIs to complete the application and registration processes as they would for conventional products.

Proof of Purchase and Payment

2. Create thresholds for documentation related to loan size to align more closely with FI risk management procedures on conventional loans.
3. Require documentation up to a percentage of loan value.
4. Accept an undertaking from the FI that loan proceeds were spent for purpose stated.
5. Accept a lawyer's trust that proceeds paid into a trust account were used for the purpose specified.
6. Drop the requirement for landlord waivers. These are hard to obtain and add little value.
7. Allow alternate security instead of a first mortgage when building owner and borrower are related.

Appraisals

8. Require appraisals for non-arm's length transactions, but not going concerns.
9. Allow FIs more flexibility in deciding whether and how to obtain appraisals.

Loan Administration and Maintenance Requirements

Administration Fee and Outstanding Balance Reports

10. Allow FIs to submit quarterly figures in Excel format.
11. IC could validate transit number and loan number at registration using FI-provided formats to reduce reconciliation errors.
12. Two FIs that track the CSBF number offered to provide more detailed reports to SBL Administration on a month-by-month basis, in exchange for dropping the requirement for an auditor's certificate.

Conversion and Prepayment Penalties

13. Deregulate conversion and prepayment penalties to allow FIs to use normal banking practices.

Substitution and Release of Security

14. Deregulate substitution and release of security provisions to allow FIs to use normal banking practices.

Other Loan Administration Concerns

15. Deregulate loan administration to allow FIs to use normal banking practices.
16. Publish regular bulletins reporting current rulings.
17. Enter into partner agreements for turnaround time on inquiries (within 24 hours).
18. Put all answers in writing so they can be attached to the relevant file.
19. Maintain a current list of FAQs online that can be used as precedents.
20. Create a link on the SBL Administration website for inquiries.
21. Institute a telephone hotline, accessible to front line people.
22. Include a cross-default provision in the regulations, so FIs can demand payment of a CSBF loan if other loans to the same borrower are in default.
23. Do not stipulate a loan term. Instead stipulate just that the government guarantee expires in ten years.

Claims Submission Process and Requirements

24. Build more flexibility into the claims process and/or the regulatory requirements.
25. Establish a quality assurance process for SBL Administration to ensure uniform service.
26. Streamline interim claim process to help FIs get defaulted loans off books.

Forms

27. Develop online "smart" forms for the program, accessible via the IC website.
28. Use a simpler form for final claims after an interim claim has been filed.

PROFITABILITY

29. Allow FIs to charge their usual fees on CSBF loans.
30. Remove the interest rate cap to allow tiered pricing and make CSBF loans a competitive product among FIs.
31. Charge lower registration and annual administration fees to lower risk borrowers.
To identify candidates, use loss history and leverage the FIs scoring systems.
32. Offer lower fees to repeat borrowers and mature companies.
33. Deregulate loan administration.
34. Remove the cap on minister's liability.
35. Reward FIs with low loss experience.

GENERAL TRENDS IN LENDING PRACTICES

36. Find ways to harmonize the program with FI administrative systems to improve speed of decision-making.
37. Increase the cap on loan size to \$500K or \$1M for real property.
38. Consider working capital loans.
39. Consider a 'patient capital' component (equity).

REPORTS

40. Report on loans and claims for each FI. Format should allow the FI to compare its own experience with results for all FIs.
41. Provide to each FI a report on the balance in the Minister's contingent liability account, by loan period.

APPENDIX I: Participating financial institutions

BMO Bank of Montreal
Canadian Western Bank
Credit Union Central of Canada
CIBC
Fédération des caisses
HSBC
National Bank
RBC Financial Group
Scotiabank
TD-Canada Trust