

REVIEW OF SME LOAN GUARANTEE PROGRAMS

Analysis and Comparison of Administrative Features

March 2007



Prepared by Heron & Company (www.heronco.ca) for:

Industry Canada
Canadian Small Business Financing Program
235 Queen Street
Ottawa ON K1A 0H5

In fulfillment of contract No. 5019040

1. EXECUTIVE SUMMARY

This study was commissioned to compare the administrative and operational processes and structures of small- and medium-size enterprise (SME) loan guarantee programs similar to the Canada Small Business Financing (CSBF) Program. The objective was to identify options for improving CSBF Program administration.

Following a web search to identify other programs, we selected those offered by the UK, US Small Business Administration (SBA), California, Korea and Japan. These were first compared on the basis of the web site information. Telephone interviews were then conducted with management personnel in the UK, SBA and California programs. We noted the main parameters of loan guarantee programs operated by several EU member countries. A table of these features may be found in [Appendix 9.1](#).

Administrative Lessons

The key objective was to understand how other jurisdictions address some of the administrative and operational challenges facing the CSBF Program.

Our main finding is that other jurisdictions have been willing and able to adapt basic features of their programs to align them with changing financial institution practices, SME financing needs and available technology.

For example:

- **Loan approval and registration turnaround times** have been addressed by reducing program administration involvement. The UK and high volume SBA programs delegate all eligibility and credit decisions to the lender. California delegates the entire loan management function to 11 non-profit corporations.
- **Claims payment turnaround** is not a factor for other programs, because they pay lender claims invoices on normal terms. Periodic on-site audits of loan files are risk-based. Claim adjustments, if any, are made in future periods, based on audit findings.
- **Claims adjustments and rejections** have been simplified and reduced by trimming the number of factors subject to regulation. Except for disallowing personal guarantees, for example, the UK program allows lenders and borrowers to interact freely and banks to use standard practices.
- **Forms requirements** have been addressed in the UK, California and some SBA programs by allowing lenders to use their own documents. The UK program has completely eliminated paper forms in favour of a web portal used by lenders to enter new loans and all loan events.
- **Reporting requirements** vary, but the UK program generates its portfolio management information and program statistics from a database populated by real time information on loan events captured on a lender portal; and the SBA is moving toward capturing loan information in real time with its E-trans model.

Options for Improvement

We were also asked to identify any features, processes or systems infrastructure that could benefit the CSBF Program. As a first step, we identified trends that have had the cumulative effect of making other programs simpler and more efficient. These include:

- Delegating decision-making authority to lenders
- Reducing or eliminating program-specific documentation
- Adopting a portfolio approach to risk management
- Adopting electronic loans management

Next we asked: What features of the CSBF Program are impeding these trends? The most significant roadblocks appear to be:

- **Focus on asset-based lending and perfected documentation.** No other program relies on asset coverage as the basis for lending. This fact alone makes comparisons with other loan administrations problematic. The asset-based approach is also at odds with mainstream commercial lending in Canada and elsewhere. Because the asset-based approach leads to a focus on perfected documentation, we believe it impedes:
 - Reducing or eliminating program-specific documentation
 - De-linking claims payment from the audit/adjustment process
 - Adopting a portfolio approach to risk management
 - Adopting electronic loans management
- **Over-regulation of program/lender and lender/borrower interaction.** No other jurisdiction has the CSBF Program's combination of a single 85% guarantee, regulated interest rates and fees, multiple rules around taking and substituting security, and a prohibition on personal guarantees. Other programs also appear to have more management latitude, for example, over preconditions for claims payment. In addition to reducing lender appetite for the Program, we believe this level of regulation impedes:
 - Delegating decision-making authority to lenders
 - De-linking claims payment from the audit/adjustment process

It is not apparent that these CSBF Program features are an effective means of controlling program losses.

We recommend Industry Canada focus on understanding and removing these roadblocks as first steps to more effective program administration.

2. CONTENTS

1. EXECUTIVE SUMMARY	2
2. CONTENTS	4
3. BACKGROUND	5
4. SCOPE	6
5. OVERVIEW OF SELECTED PROGRAMS	7
5.1. High Level Features of Selected Programs	7
5.2. UK: Small Firms Loan Guarantee Program.....	7
5.3. USA: Small Business Administration Programs—PLP and Express.....	8
5.4. California: Small Business Loan Guarantee (SBLG) Program	9
5.5. Korea: Korea Credit Guarantee Fund (KCGF)	9
5.6. Japan: JASME Agency Loans	10
5.7. EU: European Investment Fund Loan Guarantee Facility.....	10
6. ADMINISTRATIVE FEATURES	12
6.1. Incrementality	12
6.2. Cost recovery	12
6.3. Guarantee percentage.....	12
6.4. Eligibility of SMEs	13
6.5. Eligible purposes	13
6.6. Rate and fee restrictions.....	13
6.7. Credit analysis/Eligible collateral.....	13
6.8. Administrative Burden.....	13
6.9. Claims process/Adjustments and rejections	14
6.10. E-commerce	14
6.11. Risk management/Loss experience	14
6.12. Service Standards/Relations with FIs.....	15
6.13. Profile of loans/Program profitability.....	15
6.14. Improvement initiatives	15
7. OBSERVATIONS.....	17
7.1. Other programs aim for efficiency rather than cost recovery	17
7.2. Other programs have lenders certify that loans are incremental	17
7.3. No other program uses an asset-based approach to lending	17
7.4. Other programs offer lower maximum guarantees.....	17
7.5. Growth in other programs is in small loans.....	17
7.6. Other programs are less regulated.....	17
7.7. Claims payment is prompt; rejections are rare	18
7.8. E-Commerce appears best implemented as part of a program overhaul.....	18
7.9. Other programs have developed close connections to SMEs and FIs.....	18
8. RECOMMENDED AREAS FOR FURTHER STUDY	19
8.1. Closely investigate the UK SFLG Program.....	20
8.2. Investigate other EU programs	20
8.3. Study the lending processes of Canadian FIs	20
8.4. Find ways to institutionalize intimacy with FIs and SMEs	20
8.5. Learn how other programs deal with regulatory burden.....	21
9. APPENDICES	22
9.1. SME Programs in EU member countries (other than UK).....	22
9.2.. Links to Asian SME Financing Programs	22

3. BACKGROUND

The *Canada Small Business Financing (CSBF) Act* was enacted in April 1999 to build on the success of its predecessor, the *Small Business Loans Act*. The Program has two main objectives:

- Incrementality, that is, to extend financing that would otherwise have been unavailable to small- and medium-size enterprises, and
- Cost recovery

Industry Canada is responsible for administering the CSBF Program, but Canadian financial institutions (FIs) are responsible for all credit decisions and loan-making. Typically, an FI first determines whether a loan request by a SME fits within its conventional loan guidelines. If the request cannot be accommodated within the FI's credit rules, it then assesses the SME and its loan requirements to determine eligibility for a CSBF Program loan.

Main features of the CSBF Program and recent results:

- Restriction to for-profit, non-farm Canadian SMEs, with
- Annual revenues of \$5 million or less
- Maximum loan of \$250,000, maximum term of 10 years
- Up to 90% financing of eligible assets for eligible purposes
- Interest rates and fees subject to maximums
- 85% guarantee of net lender loss in case of default
- 11,112 loans for \$1 billion made in year ending March 31, 2005
- 80% of loans and 51% of dollars to firms less than 1 year old

CSBF Program loans are available through about 1,500 lenders and 15,000 service points across Canada. Program documentation and reporting is still largely paper-based, and program administration is on a loan-by-loan basis. The Directorate consulted with FIs in 2004 and received several recommendations to relax restrictions and improve administration workflow and communication, some of which have been adopted.

Canada is not alone in recognizing the positive contributions SMEs make to a national economy, and the difficulties they face in attracting start-up and growth financing. In fact, nearly all mature economies and many developing countries have implemented government guaranteed loan schemes to support small businesses.

This study is intended to provide input for future improvements in the administration of the CSBF Program. Its mission was to understand a small set of similar programs in other jurisdictions and to learn how they address the goal of helping SMEs access capital markets, while managing risk, cost, administrative burden and other constraints. As output, Section 8 contains specific areas identified for further study and possible applicability to the CSBF Program.

4. SCOPE

Our review was limited to 4 or 5 comparable loan guarantee programs. The research plan was to identify the best set of comparables and gather as much information as possible using web research, supplemented via telephone interviews and/or email.

In selecting comparables we searched for programs that were similar, to the extent possible, to the CSBF Program. Required features included:

- Focussed on SMEs
- Provide debt-based financing
- Delivered by private sector FIs
- Guaranteed or risk-shared in some way by government

Prior to commissioning this study, the CSBF Program Directorate had identified programs in the UK, US and Korea as likely comparables.

As expected, the web search uncovered a large number of SME support programs (see, for example, [Appendix 9.1](#) for a comparison of EU member programs and [Appendix 9.2](#) for links to a number of Asian programs). We narrowed the candidate list to 5 loan guarantee programs, and included the European Investment Fund (EIF) Loan Guarantee Facility as a model for increasing program leverage through secondary markets.

5. OVERVIEW OF SELECTED PROGRAMS

This section provides snapshots of the six selected programs:

- UK: Small Firms Loan Guarantee Program
- USA: Small Business Administration Preferred Lender and Express Programs
- California: Small Business Loan Guarantee Program
- Korea: Korea Credit Guarantee Fund (KCGF)
- Japan: JASME Agency Loans
- EU: European Investment Fund Loan Guarantee Facility

All currency figures in this report have been converted to Canadian dollars.

5.1. High Level Features of Selected Programs

	UK SFLG Program	USA SBA PLP, Express	California SBLG Program	Korea KCGF	Japan JASME	EU EIF Loan Gtee
Guarantee	75%	SBA PLP 75% SBA Express 50%	100% up to gtee, which may be 90%; in practice 50%	100% of gtee, which varies from 50% to 100%	100% of gtee (JASME is lender)	Negotiated by loan portfolio
Maximum size of loan	\$567,500	\$2.36 million, \$295,000 for SBA Express	\$590,000	\$2.24 million, with exceptions to \$8.7 million	\$1.17 million to \$7 million depending on approval process and end use	Unspecified, but average is \$205,000
Cost of loan guarantee (paid by borrower)	2% PA paid directly to SFLG office (government)	Registration is 0.25% under 1 year maturity, over 1 year 2%-3.75% based on size, plus 0.55% PA admin fee	Allowable as per SBA, but usually not charged	0.5-2% PA based on risk Large firms charged 0.5% surcharge	Set by JASME	NA. Loan portfolios are assembled by FIs and sold to EIF
Interest rate	Fixed by lender (No set maximum)	Prime plus 2-2.75% depending on term	Varies with% gteed up to prime +3%	Fixed by lender (No set maximum)	Fixed by JASME, reviewed every 5 yrs	As set by lender
Length of loan	10 years	7-10 years SBA Express 7 years	7 years	Length of loan guarantee matches length of underlying loan	Up to 15 years (average is 10 years)	10 years
Target firms (All need to be in jurisdiction)	Firms <\$12.7 million in revenues and <5 years old	Firms with <100 employees	Firms with <100 employees	Unspecified, but 99% of lending is to SMEs	Aimed at SMEs, but several sectors excluded	Growth-oriented SMEs <100 employees.

5.2. UK: Small Firms Loan Guarantee Program

The Small Firms Loan Guarantee (SFLG) Program, managed by the Small Business Service (SBS) of the Department of Industry and Trade, has undergone a complete redesign. The blueprint for the changes was the Graham Review on its Small Firms Loans Guarantee Program, commissioned in November 2003. Graham delivered her final recommendations in June 2004, and they were accepted and fully implemented by December 2006. For more on the Graham Review, see: http://www.hm-treasury.gov.uk/independent_reviews/graham_review/review_graham_index.cfm.

The changes included:

- Focussing guarantees on businesses less than 5 years old
- Increasing the maximum loan guarantee to \$567,500
- Simplifying eligibility requirements
- Capping lender losses to remain within a \$114 million budget

- Shifting from a loan-by-loan to portfolio risk management approach
- Moving from paper to web portal for all reporting and communications
- Using technology and outsourcing to reduce head count from 18 to 3
- Planned spin-off of financing activities from the SBS in 2007

To help implement the above-noted changes and to provide ongoing advice on SME financing activities, the UK government recruited the Capital for Enterprise Advisory Board (CFEA). CFEA is an ad hoc body that includes a former managing director of business banking at a large UK bank and a prominent venture capitalist.

The program has contracted with 25 FIs to make loans; 6 banks make 95% of program loans. Lenders agree to upload new loans and loan events to the portal within a set time following their occurrence. A separate stand-alone portal is available for FI training. FIs are responsible only for an annual report; SFLGP managers generate all reports and analysis using data accumulated on the portal. Lenders have access to their own data for analysis and also to summary information for all lenders for comparison purposes. Lenders submit an annual report on the performance of their guaranteed loans portfolio.

Each quarter, the participating FIs submit an invoice for 75% of their losses as captured on the portal. The invoice is paid immediately; audits of individual loan files are outsourced and handled on a risk management basis.

5.3. USA: Small Business Administration Programs—PLP and Express

The SBA Preferred Lender Program (PLP) is the agency's flagship program, with broad eligibility and purpose rules and a maximum loan size of \$2.36 million. Under PLP, the SBA delegates authority to FIs to do eligibility verification and credit analysis and approval. It purchases loans on default at 75% and FIs handle liquidation for a fee. PLP accounted for 19% of loans by number and 60% by value in the last fiscal year.

The SBA Express program offers a 50% guarantee on loans up to \$295,000. Lenders handle all eligibility, credit analysis, and securitization and liquidation decisions using their own systems and forms. This program has become very popular, accounting for 68% of loans by number and 24% by value in the last fiscal year.

The SBA exercises its right to do full eligibility and loan approval for about 6% of loans (the original 7(a) procedure) where there are concerns about eligibility of a SME's owners or self-dealing by an FI. Approval turnaround on these loans is 3 weeks.

In addition to generating profits for FIs, SBA loans help them meet federally mandated community lending quotas, and can be readily resold in the secondary market.

The SBA is evolving towards e-commerce and a portfolio approach to risk management. Currently about 25% of loans are handled using E-trans, the SBA's e-commerce solution. As a result of delegating authority to FIs, outsourcing audits and centralizing

remaining administration, head count for the 7(a), Preferred Lender and Express Programs has fallen from 740 in FY 2002 to 150 in FY 2006.

The SBA has a separate lender portal at: <http://www.sba.gov/banking/>.

5.4. California: Small Business Loan Guarantee (SBLG) Program

The SBLG Program, offered by the Business, Transportation and Housing Agency (BTH) of the State of California has similar eligibility requirements as the SBA program and a maximum of \$590,000. Administration of this program has been completely outsourced to 11 not-for-profit Financial Development Corporations (FDCs) around the state. Two BTH employees oversee the program.

Each FDC has a fixed allocation from a state trust fund; it can leverage this amount 4 times in guarantees on loans made by banks in its region. Each FDC commits to a target number of loans per year and earns \$4,300 per new loan and \$3,130 per renewal made. FDCs have fairly broad scope to pursue individual business strategies within the program's rules. FDCs are responsible to BTH for conserving their trust fund allocation.

As part of our research, we interviewed the CEO of Pacific Coast Region FDC (PCR). PCR has an allocation of about \$5.3 million, which supports about \$21 million in guarantees. PCR's strategy has been to focus on small loans (up to \$100,000) with guarantees of 50% or lower (average is 45%). This, plus PCR's success in raising private funds to add to its trust allocation, has allowed it to make 27% (272) of the total loan transactions state-wide and to support \$47 million in loans with only 12% of the trust fund allocation. State pay for performance is its major revenue source; because PCR goes head-to-head with the SBA Express Program, it waives fees on attractive loans. According to PCR, other FDCs are adopting this small loan, low guarantee strategy.

The other component of profitability is loss experience; PCR manages this by requiring a FICO score of 650+, lending only to businesses 2+ years old and doing complete credit reanalysis and site visits on all new loans. The result: a 5-year loss ratio of 0.38%.

PCR operates with 7 full time staff and 5 contract underwriters, paid per loan processed, and turns around loan approvals in 7 days. It outsources audits of defaulted loan files.

5.5. Korea: Korea Credit Guarantee Fund (KCGF)

This government owned financial institution issues guarantees for 11 types of financial transactions, of which bank loans account for 84%. KCGF operates out of 85 offices, processing borrower eligibility, credit checking, analysis and approval for 97% of the guarantees it issues; FIs perform credit checking as agents for the other 3%. Guarantees are stamped on loan documents, ranging from 50 to 100% of the face value in case of default. Average loan size is \$170,000.

KCGF is not restricted to SMEs, but reports that 99% of guarantees are to SMEs, which it defines as companies not traded on exchanges. It targets innovative enterprises and aims to have these firms account for 50% of loan guarantees by 2009. Another goal is to reduce its loss rate to 4% (now 7%) by 2008, but no specifics were included. Although the KCGF has been an active instrument of Korean economic policy for 30 years, the most recent annual report (2005) indicates it will undergo radical changes following soaring guarantee commitments in the wake of the early 00s Asian financial crisis. A change blueprint includes strategic plans in operations, organizational structure, human resources, and risk management, all aimed at making KCGF self-sustaining.

Our request for an interview was not returned by KCGF.

5.6. Japan: JASME Agency Loans

The Japan Finance Corporation for Small and Medium Enterprise (JASME) provides a wide range of credit instruments through its 61 offices and 2,095 employees. It targets SMEs in manufacturing, wholesale, retail and services, making direct loans of up to \$7 million to companies with between 50 and 300 employees, depending on the sector. It also supports agency loans (under which one of 527 FIs does the eligibility and credit analysis functions), and JASME provides the funds up to a maximum of \$1.7 million. Another program partially securitizes existing debt held by FIs so it can be sold in secondary markets, and partially guarantees new debt, allowing it to be securitized.

One of JASME's main functions is to provide access to capital during periods of tight credit. Another is to provide stable, long term funding; 80% of loans made by private sector FIs are repayable in 5 years or less, while 67% of JASME loans have terms greater than 5 years. The rate on a variable rate loan is reviewed only every 5 years.

We did not interview anyone at JASME.

5.7. EU: European Investment Fund Loan Guarantee Facility

European Investment Fund (EIF) is a finance body of the European Union (EU), established to support SMEs in Europe with a focus on fostering innovation and technology. Its shareholders are European Investment Bank, the European Commission and public and private financial institutions from across the EU. In addition to its loan guarantee activities, it is active in making equity investments through venture capital funds that it manages.

The EIF improves access to credit for SMEs in 2 ways:

- Facilitating securitization by purchasing dedicated portfolios of SME loans in EU member countries that have guarantee programs
- Providing direct guarantees of up to 50% to FIs for SME financing in countries such as Bulgaria, Romania, Turkey and the EFTA/EEA countries.

At 13-Dec-2005, the EIF reported its loan guarantees had supported \$12.2 billion in lending and benefited more than 250,000 SMEs. New guarantees for 2005 totaled \$2.6 billion. For all activities, the EIF reported net profit of \$57.8 million on member investments of \$927 million for its 2005 fiscal year end.

The EIF program was included as an illustration of the role of securitization in extending the amount of financing available to SMEs. Securitization is a process by which illiquid assets are converted by a corporation into a more secure (bankruptcy-remote) form for sale to investors at a lower rate than the original assets would fetch. For more on securitization, see <http://en.wikipedia.org/wiki/Securitization>.

In this case, the EIF acquires government guaranteed SME loan portfolios from FIs at a risk-based discount from face value and uses them to secure its own investment grade securities. Under their agreements with the EIF, the FIs are responsible for assembling portfolios of loans that have a similar risk profile and thus a predictable loss rate.

The result of the EIF's activity is to recycle funds back to FIs, thus increasing the total pool of funds banks have available to lend to SMEs.

We did not interview anyone at EIF.

6. ADMINISTRATIVE FEATURES

This section reviews features of comparative programs in the areas of:

- Incrementality
- Cost recovery
- Eligibility of SMEs
- Guarantee percentage
- Eligible purposes
- Rate and fee restrictions
- Credit analysis/Eligible collateral
- Administrative burden
- Claims process/Adjustments and rejections
- E-commerce
- Risk management/Loss experience
- Service standards/Relations with FIs
- Profile of loans/Program profitability
- Improvement initiatives

6.1. Incrementality

- Incrementality is a goal for all guarantee programs.
- All other programs satisfy this requirement by requiring participating FIs to certify, as part of the registration process, that they would not have made the loan on the same terms and conditions without the government guarantee.

6.2. Cost recovery

- Of all programs reviewed, only the SBA claims to be cost recoverable, and it has recently achieved this through a change in its accounting methods.
- UK spends about \$114 million per year on its guarantee program. One stipulation of the Graham Review was that the redesigned program should cost no more than the UK was previously spending (about \$136 million).
- California, which outsources its guarantee scheme, spends about \$4,012 per loan guaranteed under its pay-for-performance system, plus providing a trust fund of about \$46 million to back the guarantees.
- Japan and Korea make no mention of cost recovery, although Korea is embarking on changes to make its program more financially sound.

6.3. Guarantee percentage

- Maximum guarantee percentage among other programs relying on FI credit analysis and approval is 75%.
- All other programs except UK tailor their guarantees to loan size and risk. Most of the growth in SBA and California programs is in loans carrying 50% guarantees.

6.4. Eligibility of SMEs

- UK has shifted its eligibility focus to SMEs less than 5 years old. UK maximum revenues threshold is \$12.7 million, about 2.5 times the Canadian maximum.
- SBA/California programs are open to for-profits with 100 or fewer employees.
- Japan and Korea define SMEs more broadly but have sector restrictions.
- Some programs target new or innovative SMEs, offering preferential terms.

6.5. Eligible purposes

- Other programs allow funds to be used for any reasonable business purpose, including working capital. The main stipulation is that the funds benefit the business; thus, purchases of shares or owner payouts are not eligible. SBA allows debt refinancing, but is aware that FIs may seek to offload bad loans. Korea and Japan have broad use criteria but target guarantees at certain sectors.

6.6. Rate and fee restrictions

- Only the SBA programs and the California program, based partly upon the SBA model, restrict lenders in the rates and fees they can charge; however, lenders under these programs routinely take personal guarantees.
- In all other cases, fees and rates are fixed by the lender (not regulated).

6.7. Credit analysis/Eligible collateral

- All programs require FIs to take all available collateral, consistent with their normal practices, however,
- Only the CSBF Program requires that loans be made against specific fixed assets.
- Under other programs, FIs rely on credit scoring (e.g. FICO) and capacity to repay to drive credit decisions. The aim of loan guarantees is to reduce the minimum acceptable credit score.
- One California FDC limits lending to firms 2+ years old with 650+ FICO score.
- All except UK take personal guarantees, if available, as a matter of course. UK reports that the FI typically has the borrower's personal guarantee on a separate facility, but it cannot be taken for program loans.
- Under SBA rules, all owners of 20% or more of a borrowing business must personally guarantee the loan.

6.8. Administrative Burden

- UK is the clear winner here. Lenders register loans and enter all subsequent events on a web portal that populates a database. Each lender has access to its own data, plus summary information for all FIs. UK requires only an annual report from lenders; it audits lenders' files periodically for compliance. The program administration has not determined recourse measures, but believes they will be lenient, since the program depends on cooperation from FIs.
- SBA: Origination and credit approval have historically been burdensome for SBA loans (separate documentation, paper-based, 3 week turnaround on new loan

approvals), but under the PLP, loan origination and credit approval authority is delegated to FIs. The Express Program (maximum loan \$295,000) also allows lenders to use their own documentation and processes.

- SBA requires FIs to submit data on originated loans and has it keyed into a database for risk rating by a third party. This database is used to analyse risk by loan program, sector and FI for the life of a loan portfolio.
- SBA and California require quarterly reports from lenders on all loans.
- In California, the FDC we interviewed does complete credit reanalysis on each loan, but turns around approvals and full guarantee documentation in 1 week.

6.9. Claims process/Adjustments and rejections

- Interviewees cited the need to be reasonable with FIs, due to the small role their programs play in financial markets (typically <2% of business term lending).
- In UK, lenders roll up losses as documented in the portal and submit a claim for 75% every quarter. This is paid immediately. Lender files are audited on a risk management basis by an outsourced accounting firm(s). The spokesperson for the UK program did not anticipate large numbers of claims adjustments/denials.
- SBA historically has purchased defaulted loans immediately from lenders. Under the delegated authority programs in which the lender is responsible for liquidation, the agency is pushing off repayment for 6 months or more. Since a large percentage of SBA loans are securitized, this is raising the prospect of SBA loans becoming less attractive in secondary markets. The SBA does a 100% review of all defaulted loans. About 10% of claims are adjusted, up from 3% when claims processing was decentralized. Most adjustments relate to early defaults, and to failure either to verify that the borrower's financials agree with its IRS file, or to ensure the borrower has made an agreed cash injection.
- In California, the Pacific Coast Regional FDC (one of 11) has rejected 2 claims and denied 2 in the past 15 years. The CEO there said, "If we got a reputation for not paying off on guarantees, it would kill our program."

6.10. E-commerce

- UK stands alone as the e-commerce leader among surveyed programs.
- SBA has initiated several projects to convert to e-commerce; all have been disbanded as costs mounted. E-trans is the SBA's current e-commerce solution; it is being used for about 25% of loan originations and is growing.
- California's program delivery is too fragmented to make e-commerce feasible.

6.11. Risk management/Loss experience

- Loss ratios below represent the claims paid for a cohort of loans divided by the loan value in the cohort. They were arrived at in one of 2 ways:
 1. For SBA by calculating default rate x (1-recovery rate) x guarantee %.
 2. For others by asking interview subjects or from financial statements.
- UK loss ratio is 5.56% (based on old program parameters).

- SBA's estimated loss ratios are 2.7% for PLP and 1.7% for the Express program.
- California (all FDCs) is <1.0% (5 year average) PCR is 0.39%.
- Korea's reports a loss ratio of 7.0%.

6.12. Service Standards/Relations with FIs

- UK certifies lenders to use its program; 6 banks make 95% of program loans. This small set of channel partners enables a close relationship with UK program management. The web portal was built in collaboration with banks.
- Banks agree to update the UK program portal with new loans and each loan event within a set time after occurrence. No other action is required by the bank to register or report on individual loans.
- 350 banks make 84% of all SBA loans. SBA is working to become more FI-friendly, but the impression received is that it historically has been slow-moving and bureaucratic.
- The SBA has typically taken 3 weeks to accept a 7(a) loan; it is undertaking to accept Express loan registrations in 3 working days.
- FDCs in California work closely with banks to package and make loans. FDCs see themselves as competing with SBA Express and use speed and flexibility as competitive tools. PCR has a 7-day turnaround for full guarantee documentation on new loans and 48 hour notification on rejected new loan applications.
- UK, SBA and California programs settle claims on normal terms and reserve the right to adjust the claim payment, based on a subsequent audit of the loan file.

6.13. Profile of loans/Program profitability

- UK: Average loan size is \$85,125, but program is too new to establish baselines. Recent press articles claim the age limit restriction has caused a drop in loan volume. Program cost is expected to remain at \$114 million per year.
- SBA: Average loan size for PLP is \$556,000; average for Express is \$60,000. 67% of loans by number are SBA Express. Despite the lower guarantee (50% vs. 75%), the Express loans show higher loss ratios than PLP loans. SBA suggests this may be because Express loans are typically made without collateral. Overall, SBA claims its loan programs break even (are subsidy free).
- CA: Average loan size is US\$180,540, but current strategy of most innovative FDCs is to focus on small loans (\$60,000-\$118,000) to maximize the per loan revenues from the state. California does not appear to have a way to manage total cost of its program, since FDCs have flexibility in using their trust allocation to make few large loans or many small loans and receive same per loan fee.
- Korea: Average loan size is about \$170,000.

6.14. Improvement initiatives

- UK has a goal to decrease its loss ratio by 10% per year.
- SBA is adding portfolio management to its loan-by-loan management approach.
- SBA has consolidated all loan administration in one location from 69 offices.

- California reduced its cost per guarantee 33% over 3 years in early 00s.
- California expects to include construction bond guarantees in its program.
- Korea has launched an initiative to reduce its loss ratio to 4%
- Korea aims to increase loans to innovative SMEs to 50% of total by 2009.

7. OBSERVATIONS

Comparing other programs to the CSBF Program led to the following observations:

7.1. Other programs aim for efficiency rather than cost recovery

Only the SBA claims full cost recovery. All other jurisdictions accept there is a cost to improving SMEs' access to capital. However, several have taken steps to demonstrate and improve efficiency, including capping total program spending.

7.2. Other programs have lenders certify that loans are incremental

All other programs demonstrate incrementality by having lenders certify that loans would not be made without the available guarantee. Given the concerns expressed by Canadian FIs over the low profitability and high administrative burden associated with the CSBF Program, Program loans are almost certainly incremental.

All programs ask loan applicants to estimate numbers of jobs created/retained.

7.3. No other program uses an asset-based approach to lending

All other programs guarantee loans for most business purposes and expect FIs to base their decision on the borrower's rating and history and the business's capacity to repay.

7.4. Other programs offer lower maximum guarantees

At 85%, Canada's guarantee is the highest of any program reviewed, except for SBA Community Express, a low-volume, high-loss-rate SBA pilot program, and the Korean and Japanese programs, where the credit analysis and approval is done by the government agency. The SBA and California programs find their highest growth is in programs carrying 50% guarantees on relatively small (\$100,000) loans.

7.5. Growth in other programs is in small loans

The SBA and California report strong growth in small loans with low documentation requirements. Lenders report that they use the 50% guarantee to accept a slightly higher risk rating on loans under \$100,000.

7.6. Other programs are less regulated

The CSBF Program is unique in the number of loan parameters it controls. Other programs regulate some aspects, but accept a much larger role for FIs in packaging and collateralizing program loans. Most allow lenders to set rates and fees, all but UK have variable guarantee percentages, all have broader purpose and collateral criteria, etc.

Despite (or perhaps because of) its restrictions, the CSBF Program appears to have the highest loss ratio of the programs we reviewed.

7.7. Claims payment is prompt; rejections are rare

Other programs pay claims immediately (SBA within 6 months) and recover any amount owing from the FI once a disputed claim been resolved.

Only the SBA reported any significant level of claims adjustments (10% of total claims made are adjusted or rejected), and stated that the vast majority of these were on loans that defaulted within 18 months. SBA reported it rarely rejects claims outright. The California FDC we interviewed effectively has zero adjustments/rejections.

7.8. E-Commerce appears best implemented as part of a program overhaul

The UK's apparently successful adoption of e-commerce was part of a total program re-design and re-launch. In contrast, SBA has made several abortive attempts to introduce e-processes and is making slow progress on E-trans, its current model. Another significant UK-US difference is that the new UK program adopted a "light touch" regulatory approach and a risk management portfolio approach prior to adopting e-processes, and then partnered with FIs to develop their e-commerce portal.

7.9. Other programs have developed close connections to SMEs and FIs

"Know your customer" is a mantra (and legal requirement) among FIs. Other programs have found various ways to connect with their end users and channel partners:

- The UK recruited the Capital for Enterprise Advisory Board (CFEA), an ad hoc advisory body that includes a former head of business banking with a large UK bank and a venture capitalist. The CFEA provided advice to the SBS on implementing the Graham Review recommendations and continues to advise on program issues and proposed changes.
- The SBS also benefits from the advice of the Small Business Council (SBC), an advisory body set up in May 2000 to monitor and report on the needs of the SME community.
- The SBS manages several events annually that bring its personnel face-to-face with members of the UK SME community.
- 95% of loans under the UK SFLG Program are made by 6 FIs; in all only 25 FIs are permitted to deliver program loans. This number allows the 3 SFLG Program managers to invest in developing relationships.
- In California the state uses community-based not-for-profit corporations (FDCs) to market and manage its program working closely with FIs, in exchange for pay-for-performance. Two state employees oversee the corporations.
- The SBA maintains offices 69 offices across the US, through which it provides counselling and other services directly to SMEs.
- The government corporations delivering loan guarantee programs in Japan and Korea maintain dozens of offices in their respective nations to work directly with borrowers and make site visits to prospective borrowers.

8. RECOMMENDED AREAS FOR FURTHER STUDY

The CSBF Program Directorate, which commissioned this study, is responsible for the administration of the CSBF loan program. Among other factors, the directorate is regularly asked to account for:

- Volume of CSBF Program loans
- Cost recovery
- Level of administrative burden on financial institutions

Although this study focussed on the administrative features of other programs as a path to improvement, it became clear that the Canadian program is fundamentally different from all other loan guarantee schemes we examined. This is significant, since it directly impacts the Directorate's ability to fulfill its responsibilities. Among its differences, the CSBF Program:

- **Is asset-based:** This is in sharp contrast to other programs and the business lending practices of Canadian FIs (its channel partners). The development of widely accepted credit scoring systems and norms and the free exchange of credit information have made the creditworthiness of the borrower and the business's ability to repay the basis for lending in all developed economies. This approach to risk is also the basis for securitizing SME loan portfolios in other jurisdictions, which in turn expands the credit available to SMEs.
- **Offers a single 85% guarantee:** No similar program offers guarantees of more than 75%. Some offer a range of guarantees, based on loan size and risk. The fastest growing group of loans in US jurisdictions carries guarantees in the range of 50%. The guarantee percent is significant, because it directly impacts an FI's appetite and attitude towards risk.
- **Excludes working capital:** All other programs facilitate access to working capital. We doubt many Canadians could see how a loan secured by a first mortgage on a new restaurant's leasehold improvements or on custom computer software is more deserving of a guarantee than one, for example, to facilitate a management buy-out of a going concern, secured by inventory and receivables.
- **Regulates FI practices:** Other programs allow its channel partners wider latitude in lender-borrower interaction and loan management, for example in taking and substituting security. Considering that CSBF Program loans account for well under 0.5% of total bank business lending in Canada, the nuisance to FIs of having to comply with non-standard procedures is a source of concern.
- **Uses documentation defects to adjust/reject claims:** Although all program administrations reserve the right to adjust or reject claims in the case of serious loan management lapses or bad faith on the part of FIs, none appears to focus on documentation flaws (proof of purchase, proof of payment, for example) as a basis for adjusting a claim payment. All programs report rejections are rare.
- **Conducts in-house loan-by-loan reviews:** Other programs have moved or are moving to a portfolio approach to risk management, supported by technology. Lender claims are paid immediately and audits of lender files are outsourced to

third parties. As a result, the UK now has 3 people managing its program, and California has 2. The SBA has 150 people administering the 7(a) family of loans and is downsizing. It has not fully implemented a portfolio approach, still does eligibility and credit analysis on 5,700 loans per year, manages 6 programs and guarantees about 14 times the number of loans annually as the CSBF Program.

To uncover all possible improvement opportunities we recommend the Directorate:

8.1. Closely investigate the UK SFLG Program

We recommend more study of the UK model and the thinking behind it, especially:

- The decision to focus on a subset of FIs and contract with each FI
- The choice of a single 75% guarantee and possible future changes
- The web portal design and implementation, including lessons learned
- The portal-driven loan database, its design and reports generated
- The use of advisory boards, their make-up and mandates
- Portfolio management, light touch regulation, third party audit contracts
- Reasons for spinning off the SFLG Program and other financing activities
- Performance indicators: volume, FI acceptance, loss ratio*, other costs

*The UK loss ratio (currently 5.6%) bears close monitoring, because it is the only other program we surveyed that does not allow the taking of personal guarantees.

8.2. Investigate other EU programs

We recommend study of the loan guarantee schemes operated by other EU member states ([see Appendix 9.1](#)).

EU members are good research candidates because their economies and banking systems are similar to Canada's in terms of maturity and several are similar in size at \$1 trillion GDP. In addition to loan administration, it would be valuable to understand their attitudes towards regulating the interaction between lender and borrower.

8.3. Study the lending processes of Canadian FIs

We recommend an in-depth study by CSBF Program Directorate personnel of how Canadian FIs make and manage loans. This would serve three purposes:

- Understand the risk management approach of modern credit practices.
- Understand the impact of CSBF Program on FI activities.
- Identify ways to align the CSBF Program with our channel partners' processes in the interest of making more financing available to Canadian SMEs at the same or lower cost.

8.4. Find ways to institutionalize intimacy with FIs and SMEs

We recommend the CSBF Program Directorate seek a suitable vehicle for engaging in regular dialogue with individuals that really understand FIs and SMEs. This cannot be

accomplished by studies, infrequent consultations, or contact with industry organizations. What is needed is frequent and open dialogue with individuals who are, or have been, in the trenches of the business lending and SME communities.

We recommend Industry Canada consider two UK examples:

- The Capital for Enterprise Advisory Board (CFEA), an ad hoc body, was recruited to provide business-focussed advice and leadership and to oversee the activities of the Investment Fund Management Directorate of the SBS. The CFEA advised on the changes to the SFLGP resulting from the Graham Review and continues to supply input on ideas for proposed improvements.
- The Small Business Council (SBC) may also be a useful model. Link to the SBC is: <http://www.sbs.gov.uk/sbsgov/action/layer?topicId=7000013887>.

As a separate issue, we recommend the directorate develop closer channel partner relations with individual FIs, focussing on the major program lenders.

8.5. Learn how other programs deal with regulatory burden

Change is so pervasive it has become cliché. Whatever administrative changes are made to the CSBF Program to address current challenges, the characteristics and needs of the Canadian FI and SME communities will continue to evolve. How can the Program become flexible enough to keep pace with its channel partners and ultimate clients? The UK is slated to spin off SME financing functions from the SBS in 2007. California has completely outsourced its loan program to intermediaries with great latitude within broad parameters. We recommend these and other options be explored for lessons.

9. APPENDICES

9.1. SME Programs in EU member countries (other than UK)

	Netherlands BBMKB	Denmark Vaekstaution	Belgium SOWALFIN	France SOFARIS	Germany Burschaftsbanken
Guarantee	Up to 50% Up to 75% for start ups and innovative companies	66.67% up to \$795,000 50% from \$795,000 to \$1.59 million	Up to 75%	Varies – generally around 50% (average of 45% for 2001) Up to 70% for start ups	Up to 80% (average between 50-80%)
Maximum size of loan	\$2.27 million	\$1.59 million (minimum of \$227,000)	\$5.7 million	No limit on loan size, but SOFARIS' risk is limited to 1.59 million (up to \$3.4 million for SME transmission and development)	\$2.27 million
Cost of loan	One-off commission of 2%-3.6%	3% PA in first 2 years. 1.5% thereafter	1% PA on guaranteed exposure (paid as an up-front, one-off fee)	Annual fee of 0.45- 0.60% on the outstanding amount	0.75% commission on amount guaranteed Premium of 1% PA (can be 1.2% for first operation, then 0.8%)
Interest rate	Fixed by Government (usually equal to a low- risk rate but the commission is passed on by lenders to borrowers)	Fixed by lender	Fixed by lender	Fixed by lender (subject to restrictions ensuring it is a market rate)	Fixed by lender
Length of loan	Maximum 6 years (maximum 12 years for real estate)	3-10 years	Maximum 10 years (but lender can request longer)	Length of loan guarantee matches length of underlying loan	Up to 15 years (average is 10 years)
Target firms	Firms up to 100 employees. Special consideration for start-ups and innovative companies	SMEs in 6 focus areas	All SMEs	All SMEs in all phases of their existence – are 10 different guarantee funds managed by SOFARIS	All with focus on start ups

Adapted from: Graham Review Recommendations 2004, page 77

9.2. Links to Asian SME Financing Programs

Indonesia <http://www.askrindo.co.id/en/index.php?bahasa=en>

Malaysia <http://www.iguarantee.com.my/iguarantee/nef.htm>

Nepal [http://www.dicgc.org.np/cgi-](http://www.dicgc.org.np/cgi-bin/ewf/scripts/elixir_website_framework_page_loader.cgi?page=establishment.src)

[bin/ewf/scripts/elixir_website_framework_page_loader.cgi?page=establishment.src](http://www.dicgc.org.np/cgi-bin/ewf/scripts/elixir_website_framework_page_loader.cgi?page=establishment.src)

Philippines <http://www.sbgfc.org.ph/creditdelstrat/credit/index.htm>

Taiwan http://www.smeg.org.tw/english/credit_guarantee/eligible_institutions.htm

NOTE: We did not find SME loan guarantee programs in Australia or New Zealand.