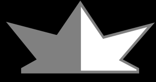

Task Force on the
Future of the
Canadian Financial
Services Sector

September 1998

change challenge opportunity

Canadians' Expectations and Corporate Conduct

Background
Paper #4

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Chapter 1

Introduction

This paper deals with how financial institutions conduct themselves in meeting the expectations of the communities within which they function. Canadians have high expectations of their financial institutions, and particularly of banks. These expectations appear to be based upon two considerations.

The first is the importance of financial institutions to the health of the economy and the well-being of individual Canadians. The services that banks, in particular, have historically provided – as custodians of people's savings, facilitators of payments and providers of credit – distinguish them from other large corporations.

The second consideration is the perception that financial institutions and, once again, banks in particular are privileged institutions that have historically benefited from the support and protection of governments.

Many would argue that because of these privileges and their importance, banks must meet higher expectations with respect to their social and business performance than other businesses, and even than other financial institutions.

The Task Force believes that a healthy relationship between financial institutions and the communities they serve is critical to a well-functioning financial services marketplace. Canadians should have confidence that their financial institutions are contributing to the community in a positive, constructive way. The Task Force also believes that it is timely to examine this relationship because it does not appear to be as healthy as it could or should be. As the financial services sector continues to evolve and as lines of demarcation between financial institutions continue to blur, it will be important to develop a foundation for a healthy relationship between the community and all financial institutions, not just banks.

This paper explores the relationship between the performance of financial institutions and the community, focussing on how well the institutions meet community expectations.

The bulk of the paper deals with banks and, more particularly, the Canadian chartered banks. As explained in Chapter 2, this is because the Task Force believes that Canadians have higher expectations of the Canadian chartered banks than they have of other financial institutions. The higher expectations

appear to derive from the importance of banks in the economic life of Canadians and communities, coupled with the historical development of Canada's financial system, in which government policy assisted the development of large national banks. To a lesser extent the expectations apply as well to other deposit-taking institutions, including credit unions, caisses populaires and trust companies.

As a result of the recommendations of the Task Force and the forces of change bearing on the financial sector, banks will either lose some of their historical privileges or share them with other financial institutions. In consequence, the Task Force believes banks will become less "special" and other financial institutions will become more bank-like. Although the paper focusses particularly on banks, the principles underlying the document apply equally to all financial institutions, and the proposals and recommendations of the Task Force with respect to corporate conduct will become increasingly relevant to all financial institutions.

Public Expectations

Chapter 2 examines the basis for the higher expectations that the public appears to hold with respect to the performance of banks. The chapter reviews the privileges that banks have historically been said to have. It argues that many of these so-called privileges stem from public policy desires to protect the safety and soundness of the banking system. They confer benefits not only on the banks but on Canadians generally. Although some of them can be eliminated, many of them cannot and should not be removed. The chapter also makes the point that removing the privileges cannot remove the legacy they have left: a strong national banking system that dominates the financial services landscape. The conclusion is that higher public expectations will remain, and legitimately so, and that institutions should realize this and endeavour to conduct themselves in a manner that recognizes their broad responsibilities to many stakeholders, in addition to their shareholders.

The expectations that Canadians hold of their banks demand responsive behaviour from banks with respect to both social performance and aspects of their business performance.

Social Performance

Chapter 3 reviews some areas of banks' activities where the public has high expectations that banks will act in a socially responsible way, even if the activity may not be profitable or as highly profitable as other activities. These areas include access to basic financial services where the provision of these services may not be a viable business proposition but where their absence presents serious consequences for Canadians. The areas include as well the provision of micro-credit, partnership with the voluntary sector and investment in communities.

Business Performance

Chapter 4 examines some aspects of banks' business performance where, even though the activity is profitable, the community has demonstrated continuing concern about whether the banks are devoting adequate resources and attention to meeting the demands that exist. In particular, the chapter reviews recent practice and some continuing issues surrounding the availability of financing to small and medium-size enterprises (SMEs), and to firms in the knowledge-based industries (KBIs) that form the foundation of the "new economy."

Chapter 2

Banks and Public Expectations

This chapter deals with:

- the need to re-assess the relationship between banks and the community;
- the basis for community expectations; and
- meeting community expectations.

The Relationship between Banks and the Community

Banks have always had a special place in the Canadian economy. The development of a transcontinental Canadian economy was sustained and fostered by strong national banks. In turn, national policy supported a vigorous, nationwide banking system through high entry requirements, protection from foreign competition, and a safety net that protected depositors and sometimes banks. For long periods in our history, maximum lending rates were regulated; within this framework, banks collectively set interest rates paid to savers and charged to borrowers. Until 1980, the banks together owned, operated and had exclusive access to the national payments system. Whatever the value of the banks' privileges today, their strong position in the contemporary economy reflects the heritage of our past.

This position places banks in a special relationship with the community, more so than other industries. The community holds higher expectations of banks. Public opinion research shows that a majority (58 percent) of Canadians believe that banks have greater public responsibilities than other businesses.[1] They hold the banks to different standards and expectations in their conduct and in their accountability to the local and national communities to which they belong. Canadians expect to be well served by banks in the normal course of business. They also expect banks to play leadership roles in their communities. As stated in the Task Force's Discussion Paper, "In our society, it is accepted that ownership of a regulated financial institution is a privilege, not a right."[2]

[1] In a recent survey, 58 percent of respondents stated that they disagreed with the statement, "Banks do not have any public responsibilities compared to other businesses." Only 26 percent agreed and 14 percent neither agreed nor disagreed. See Ekos Research, ***Public Opinion Research Relating to the Financial Services Sector***, Research Paper Prepared for the Task Force on the Future of the Canadian Financial Services Sector (Ottawa: September 1998), Exhibit 6.2, p. 41.

[2] Task Force on the Future of the Canadian Financial Services Sector, Discussion Paper, June 1997, p. 1.

This special position places banks under closer scrutiny than other businesses. The Bank Act under which they operate has a fixed term that requires periodic review and renewal, at one time every ten years and now every five. At critical times, the Government has commissioned special reviews of the financial system – one in the midst of the Depression and the other at a crossroads in the 1960s. Each left its indelible mark.[3]

A new look at the conduct of the banks and other financial institutions in terms of their responsibility to the community is now appropriate for several reasons:

- Canada is shifting to an information-based and service-based economy.

  The Canadian economy has been shifting more and more to a service economy. Two of every three workers are now employed in producing services, many in industries where knowledge forms their most important asset. Adequate financing for these new industries, like any other, is critical to their ability to grow and prosper. The granting of credit – the stock in trade of commercial banks – has traditionally been based on security of physical assets used to produce goods. Many have expressed concern about whether banks and other financial institutions can meet the distinctive challenges of financing this new economy. If they cannot or will not, what measures are necessary to ensure appropriate flows of credit and other types of financing to the industries of the new economy?

- The business of banks and other financial institutions is converging.

  The financial sector faces rapid change fuelled by new technology, globalization and demographic shifts. These, together with regulatory change, have transformed the financial industry in fundamental ways, linking businesses formerly confined to separate activities and blurring differences between financial activities. The changes give cause to reconsider the special position of banks in the community. Should other institutions such as trust companies, insurance companies and mutual funds be subject to the same expectations as they become closer to banks in their business, or does the reduced distinctiveness of banks reduce the community's expectations of them?

- The relationship between banks and the community is not healthy and has recently deteriorated.

[3] The Macmillan Committee of the 1930s recommended the establishment of a central bank. The Porter Commission of the 1960s has served as a guide and standard for subsequent reviews of the financial framework.

> Community support for banks suffered when many small businesses were abandoned by the withdrawal of credit in the downturn of the early 1990s. Research conducted for the Task Force indicates that Canadians generally tend to view banks as responsible employers (46 percent) and good corporate citizens (44 percent).[4] However, the public now places low trust in senior bank executives,[5] while 44 percent of Canadians feel that banks are "heartless," and almost 60 percent believe that the large banks "exert too much influence and power in Canada."[6]

Banks do play a very important role in our communities. The five biggest banks are by far the largest contributors to charitable causes, donating an estimated $78.5 million in 1997.[7] Banks are major employers and bank employees, from branch managers down, have traditionally played leadership roles in community activities. Many of the contributions that banks make to the quality of life are not widely enough known or deeply enough understood. A better understanding of the relationship between banks and communities, and areas in which the relationship can be enhanced, would be beneficial.

The Basis for Community Expectations

Some suggest that banks are effectively public utilities and should be treated as such. Public utilities offer essential services that cannot be obtained from other sources; they have natural monopolies that dictate a single provider; and they have exclusive jurisdiction over geographic areas. In the view of the Task Force, banks are not public utilities. Few bank services cannot be provided by others. Individual banks are not granted sole jurisdiction to serve a community or a defined area.

Others suggest that banks should be viewed no differently from other businesses, and that the community should thus have no special expectations about their conduct or accountability. The Task Force does not accept this view. The charters of banks, their special powers and their privileges have all been granted by government. Without this framework, banks would be very different from what they are today. They would not enjoy the same degree of public confidence, needed to hold the public's deposits, that they now do.

In virtually all countries banks fall in a middle range between public utilities and pure commercial entities. In all social democracies bank charters are given by governments, and governments take responsibility for the regulation of their

4 Ekos Research, op.cit., Exhibit 6.1, p. 40.

5 Only 31 percent of respondents indicate high levels of trust in Chief Executive Officers (CEOs) of large banks, compared with 40 percent for insurance brokers and 59 percent for local branch managers. Ibid., Exhibit 5.2, p. 39.

6 Ibid., Exhibit 6.2, p. 41.

7 Canadian Centre for Business in the Community, reported in the *Globe and Mail*, January 29, 1998.

banks, both domestically and in dealings with governments of other countries in which their banks operate. In Canada, public policies have aimed at facilitating the development of strong, large banks with national reach.

The extent to which banks have a privileged position within the economy has been the subject of debate. The Canadian Community Reinvestment Coalition (CCRC) argues that chartered banks must be responsible to the community because they enjoy special privileges.[8] The Canadian Bankers Association (CBA) has challenged the view that banks have a privileged position in the Canadian economy. It argues against any extra accountability for banks as follows:

> Canada's banks believe that their performance should be measured against standards that apply to all responsible business.... Ultimately, decisions about the regulation for the financial services sector should be founded on the principle that private sector financial institutions are businesses, not public utilities.[9]

The privileges that are generally alleged to be enjoyed by Canadian banks include:

- the wide-ownership requirements for Schedule I banks;
- a restrictive foreign bank entry policy;
- the so-called "too big to fail" doctrine;
- Canada Deposit Insurance Corporation (CDIC) insurance coverage for federally regulated deposit-takers;
- access to liquidity support from the Bank of Canada;
- access to the payments system; and
- national regulation that enhances banks' ability to pursue international activities.

Whether or not these are privileges, they are realities. And these realities are the results of policies that bring clear benefits to the banks and to the community at large. In the past these policies have been an important force shaping the character, size and structure of the chartered banks and their place in the financial system. Many of them are also the means by which the government protects the safety and soundness of the financial system.

Some privileges – for example, protection from foreign entry, government support of compensation schemes, access to liquidity support, and access to the payments system – could be removed or possibly shared with other financial institutions without harm to the financial system. Indeed, the removal or

[8] Canadian Community Reinvestment Coalition, *An Accountability System for Financial Institutions in Canada: How to Ensure They Meet a Higher Standard of Performance*, Position Paper 5 (December 1997), p.6.

[9] Canadian Bankers Association, Submission to the Task Force on the Future of the Canadian Financial Services Sector, p. 45 ff.

sharing of some of these privileges could bring benefits to Canadians. In many of these areas, the Task Force is recommending changes which, taken together, will reduce the privileged position of the banks and lead to more dynamic and vigorous competition.

Most of these privileges, however, are at the base of a broader public policy framework. While they might be extended to other financial institutions to promote competition, they cannot be removed without threatening the health and vitality of the Canadian financial system.

Even if such privileges could be removed, the strong market position the banks enjoy today would remain as a beneficial legacy of our past. History cannot be reversed. And it is the broad sweep of our history that forms the basis for public expectations with respect to the behaviour of banks.

Meeting Community Expectations

The special position of banks in our society leads to two types of expectations:

- Banks are expected to play a leadership role in the community, beyond their narrow business imperatives. They are expected to contribute to enhancing the quality of life of citizens through social responsibility and good corporate citizenship, by undertaking activities that may or may not be profitable.
- Banks are also expected, in their business dealings, to support the community. No one would ask or expect banks to adopt decisions that do not make business sense. But there is concern that banks may decline to make profitable loans within the community because the risk-adjusted returns are not great enough or the administrative costs are too burdensome compared with alternatives that may benefit shareholders but not other stakeholders.

Expectations about Social Performance

There are four specific areas, described more fully in Chapter 3, where the Task Force has heard representations about the social performance that many expect from banks. These include access of Canadians to basic banking services, provision of micro-credit, relationships with the voluntary sector and investment in communities.

Access to basic banking services

Access to banking services is becoming essential for everyday living. Most Canadians believe that it is essential to have a bank account but studies show that a significant number of Canadians lack one – i.e., are "unbanked." Banks, working through the CBA and with government and social groups, have developed policies that would assist many Canadians to avail themselves of basic banking services. Concern with access to branches is also

growing in importance as banks seek to reduce costs and operate more efficiently, and as further consolidation in the industry is contemplated.

Support for micro-credit

Micro-credit programs are directed at individuals, many of them marginalized, who have business plans, or at least ideas, that may require small amounts of funding. Often these credit programs are tied to other initiatives, such as community economic development programs. The Task Force received a number of submissions about the positive role that micro-credit is playing and can play in communities across the country.

Relationships with the voluntary sector

The Task Force received a submission from the Voluntary Sector Roundtable, which outlined a number of ways in which the financial sector could work more closely in partnership with the voluntary sector in Canada.[10]

Investment in communities

The Community Reinvestment Act (CRA) in the United States requires banks to satisfy the service and credit needs of the communities where they are located, in a manner consistent with the safe and sound operation of the institution.[11] It operates by disclosure by banks of lending, investment and service activities within communities including credit granted to small businesses. Regulators grade banks' efforts and the results are made public. Regulators take performance into account when permission is required to undertake major transactions or to change powers or structures.

Expectations about Business Performance

Lending to business, especially SMEs, is a core function of banks. Their relationships with SMEs are profitable for them. There is, nevertheless, a continuing public concern that banks may not be doing enough to finance SMEs. The concern arises because such businesses have few alternatives and are so important to our economy.

SMEs are powerful engines of employment and growth. Their health is important to the economic well-being of most Canadians. Within the SME community, firms in KBIs have particular difficulties in accessing financing, and are critically important to innovation and Canada's competitive position.

[10] Voluntary Sector Roundtable, *Presentation to the Task Force on the Future of the Canadian Financial Services Sector*, April 8, 1998.

[11] Canadian Community Reinvestment Coalition, op.cit., p.14.

The banks' role in assessing and granting credit creates a tension in the relationship between bank and customer that is not evident with respect to most other types of business. The fact that some potential borrowers are turned down is not, by itself, an indicator that credit markets are working poorly. As stewards of other people's money, banks should not lend when the interest earned will not compensate for the borrower's risks and when there is not a reasonable chance of being repaid.

The difficult issue is how to judge whether legitimate, credit-worthy demands are not being met. There have been a number of studies aimed at detecting whether credit market gaps exist. Most of these studies have not been conclusive. However, in the recession of the early 1990s, banks tightened credit significantly for many SMEs; in retrospect, most observers – including some within the banking community – acknowledge that there was an overreaction. The result was that small business lending underwent an intensive review exercise by the community through Members of Parliament and government-sponsored committees, with no fewer than four reports on the subject being delivered in 1994.[12] The message is clear: if the public believes that a function as critical as lending to SMEs is not being done well, it will demand greater intervention in the business of banks to correct what it perceives as unfair practices.

A further discussion of issues arising in the financing of SMEs and KBI firms is presented in Chapter 4 of this paper.

[12] These were the Report of the Standing Committee on Industry (Berger Committee). *Taking Care of Small Business* October 1994; Federal Ontario Liberal Caucus (Mitchell Committee), *Report of the Task Force on Access to Capital by Small Business*, August 1994; Small Business Working Committee, *Breaking Through the Barriers: Forging Our Future*, 1994; and Industry Canada (Toriel Committee) *Financing the New Economy*, June 1994.

Chapter 3

Public Expectations and the Social Performance of Financial Institutions

This chapter discusses issues and proposals related to:

- access of low-income individuals to basic banking services;
- access of communities to services through branches;
- access of individuals to micro-credit;
- partnerships with the voluntary sector;
- investment in communities; and
- a community accountability statement.

Access of Low-income Individuals to Basic Banking Services

At present, a deposit account that can be used to make payments is at the core of most people's needs for financial services. Changing technology in the deposit-taking industry seems certain to affect the access of low-income Canadians to financial services. Most changes seem likely to reinforce the need for such an account. These include the movement away from branches toward services through automated teller machines (ATMs), the Internet and telephone banking.

For most Canadians, the issue of access to the services of a deposit-taking institution is not a concern. They have full financial services readily available at a convenient branch of a bank or trust company, or at a credit union or caisse populaire. For low-income Canadians, such access to financial services cannot be assumed. They may lack identification or other requirements for opening an account at a financial institution; they may be deterred by the procedures to be followed in setting up an account or finding the best account for their needs; or they may not wish to have an account because of the fear that their funds may be seized or their account frozen.

In dealing with the issue of access for low-income Canadians to the services of financial institutions, this section:

- describes the public interest in access to basic banking services;
- examines the evidence with respect to the present state of access;
- outlines the recent measures taken to improve access; and
- sets out approaches to improving access.

The Public Interest in Access

Access to banking services for low-income Canadians refers to their ability to receive funds and make payments without undue cost or inconvenience. Depending on circumstances, this may include the ability to have a deposit account to hold funds and make payments; the ability to access funds on deposit without delay, particularly funds that come via government cheque; and the ability to cash cheques.

Public concern about access to banking services for lower-income groups has been quite recent, even though the ability to make payments has been essential in a modern economy for many years. Lack of access may be a greater problem in the future because of trends in payments technology. Currency once provided a means of payment usable by all but now is in danger of being increasingly marginalized. Already certain types of payments are difficult to make by cash.[13] Low-income people may face the need to move from currency to new, more sophisticated forms of payment, often electronically based, while lacking any relationship with a financial institution to give them a point of entry.

Even where cash can be used, lack of a bank account may make it expensive to acquire the cash needed to carry out everyday transactions. The alternative of cashing a cheque in a local store often requires a minimum level of purchases. Cheque-cashing stores demand service charges as high as 2.95 percent of the value of the cheque plus $1.99 for each cheque cashed. A single person receiving Metro Toronto welfare payments of $520 per month, for example, would pay $208 per year to cash cheques at a cheque-cashing store.[14]

The issue of access for low-income Canadians raises the following questions:

- Should ensuring reasonable access to banking services to low-income Canadians be a policy goal?

[13] Options Consommateurs reports that neither Bell Canada nor Videotron accept cash. Presentation to the Task Force, October 8, 1997.

[14] Michael Grant, *Canada's Social Payment Disbursement System and the Financial Services Sector*, Research Paper Prepared for the Task Force on the Future of the Canadian Financial Services Sector, September 1998, p. 30.

According to research conducted for the Task Force, a strong majority of Canadians view it as essential that all Canadians have access to basic banking services and products. The highest priorities were the ability to cash a cheque, viewed as essential or important by 95 percent of those surveyed, and access to a basic chequing account, viewed as essential or important by 85 percent. Though given lower priority, the ability for all Canadians to have a bank card or to pay bills through a financial institution was seen as essential or important by 75 percent and 76 percent of respondents respectively.[15]

The Task Force recognizes the importance of access to banking services in a modern economy and the costs that are borne by people who lack access. It believes that reasonable access is within reach if the government, financial institutions and social groups treat access as a very important policy objective and work together to attain it.

- What does reasonable access mean in terms of services?

Reasonable access to basic banking services means different things to different people. For most, access could be expressed in terms of a basic account meeting an individual's need for banking services; this would be available to all and would be well known throughout the community. Such a basic account should be defined in terms of the minimum banking services required in a modern economy.

Changing technology may also affect the public's view of reasonable access. Soon, the development of smart cards may permit people to receive funds and make payments without the need to have a deposit account. When this happens, the banking services associated with basic access may need to be redefined.

- How should access be achieved?

Only a minority of Canadians believe that access for low-income Canadians should be ensured by either government (11 percent) or financial institutions (29 percent) acting alone.[16] The majority of those surveyed (55 percent) believe that access to financial services should be a joint responsibility of government and financial institutions. The Task Force shares this view. Clearly, an important way in which the public expects financial institutions to make a social contribution is by cooperating with governments to improve access.

[15] Ekos Research, op. cit., Exhibit 3.1, p. 22.

[16] Ibid., p. 23

Evidence on Access

Availability of Accounts

Any effort to measure the number of individuals lacking deposit services is very difficult. Those individuals most likely to lack access to financial services often do not have a fixed address and cannot be reached by telephone. As a result, they will also be the most difficult to reach by normal survey methodology. A U.S. expert on access illustrated the difficulties inherent in estimating the extent of access problems by citing three sets of data on the unbanked as a share of the U.S. population. The data give a range that runs from 6 to 22 percent, with a middle estimate of 13 percent.[17]

The available evidence suggests that the Canadian problem with access is less severe. Survey data collected by Environics for ACEF-Centre in 1995 indicate that as many as 3 percent of Canadians over the age of 18, or some 650,000 people, did not have accounts with financial institutions.[18] The data show the following:

- The share without banking services falls to 2 percent among Quebec residents. In contrast, 6 percent of the residents of the Atlantic Provinces lack banking services.
- The most striking differences are between income groups. Some 8 percent of individuals with incomes below $25,000 did not have banking services. This figure did not exceed 1 percent for any other income group.

The more recent survey conducted for the Task Force by Ekos Research showed findings generally consistent with those of ACEF-Centre.[19] While the survey found that only 2 percent of those surveyed did not have accounts, Ekos recognized that the figure was an understatement because lower socio-economic groups were likely to be underrepresented. Ekos concluded that the overall figure could be in the range of 2 to 4 percent. It also found lack of access higher among the poor and the elderly. Five percent of households with incomes below $20,000 and 3 to 4 percent of Canadians over age 65 did not have accounts.

[17] John Caskey, “Defining the Market”, in Comptroller of the Currency, *Financial Access in the 21st Century*, Proceedings of a Forum held on February 11, 1997, Washington, DC.

[18] ACEF-Centre is now known as Options Consommateurs. This research was found in *The highs and lows of access to banking services in Canada*, Report to Industry Canada, January 1996. Respondents filled out a self-administered questionnaire under the supervision of a professional interviewer. The sample was chosen on the basis of place of residence and, as a result, avoided some of the possible bias in telephone surveys with respect to the coverage of low-income people. It may not have avoided language bias with recent immigrants, a group found in other countries to have problems with access. It would also have limited coverage of the homeless, a group not likely to have accounts.

[19] Ekos Research, op. cit., p. 12.

Surprisingly, Ekos found that most individuals who did not have a bank account, when asked why, responded that they "either did not need or want an account, or disliked banks."[20] This finding is hard to interpret since it is based on a very small sample size.

Affordability of Accounts

Research conducted for the Task Force shows that Canadian banks now offer basic accounts with reasonable fees. Exhibit 3.1 shows the lowest monthly fees for an account with eight withdrawals per month, offered by each of the six major banks. Three alternatives (high, low and medium cost) are presented in each case.

Exhibit 3.1
Basic Accounts Offered by Major Canadian Banks as of June 5, 1998
(Canadian dollars)

	Account type	Low cost: 8 withdrawals (8 ATMs) fees per month	Medium cost: 8 withdrawals (2 cheques, 2 in-branch, 4 ATMs) fees per month	High cost: 8 withdrawals (8 cheques) fees per month
Bank of Montreal	First Bank Chequing	$3.00	$4.20	$4.80
CIBC	Menu Plus 10-pack	$2.80	$3.40	$4.00
National Bank	Progress Account	$4.60	$5.80	$5.40
Royal Bank	Signature Plus	$3.00	$3.20	$3.60
Scotia Bank	Scotia Basic Banking Acct.	$1.70	$1.70	$1.70
TD Bank	TD Moneybuilder	$4.20	$5.00	$5.80
New York basic banking account		$4.40	$4.40	$4.40

Sources: Financial Service Charges Calculator, Industry Canada. New York State, Banking Department, Basic Banking Accounts/Lifeline Banking Accounts at www.banking.state.ny.us/bba.htm

The fees on these Canadian accounts can be compared with those of the basic account that New York State requires banks to make available. This account offers eight withdrawals per month for a maximum monthly fee of $C4.40.[21] Exhibit 3.1 shows that the fees for accounts at five of the six Canadian banks for the low-cost pattern of transactions, and four of the six for the medium-cost pattern, were below the New York maximum. Three of the six fall under the limit

[20] Ekos Research, ibid., p. 12.

[21] Service charges on the New York account are converted into Canadian dollars at the average exchange rate for June 1998 reported by the Bank of Canada.

even with the high-cost pattern of transactions. There appear to be accounts available in Canada that are on a par with New York State's basic account.

The Problem of Holds on Funds

The Task Force has also heard from community groups about problems that people have had with respect to holds placed on funds, and particularly on cheques issued by governments. Options Consommateurs, Veith House and the Canadian Community Reinvestment Coalition have identified such problems. In research for the Task Force, Michael Grant described experiences where low-income people have faced holds on their funds for periods in excess of 1 week and up to 10 days on government cheques.[22]

These experiences have been confirmed by the Ekos survey of consumers.[23] Close to one in five Canadians reported facing a holding period before being able to use funds deposited in their accounts, and as many as 8 percent reported holds on cheques from governments. The frequency of reported holds was greatest among the young and lower-income groups. Together, 27 percent of survey respondents in these groups reported that holds had been placed on cheques, while 15 percent of younger people experienced holds on government cheques. More than two thirds of those experiencing holds found them to be "somewhat of a problem" or "a problem."

Recent Measures to Improve Access

Banks and governments have taken initiatives to improve access to financial services for low-income Canadians:

- Major banks have reached agreement with the federal government on policies and practices for opening accounts.
- Some governments at all levels have acted to improve access to financial services through increasing use of direct deposit and by entering into indemnity agreements with financial institutions. Direct deposit programs can help low-income individuals open accounts, and some indemnification measures eliminate holds on government cheques deposited by account holders. Indemnification agreements also allow non-customers to cash government cheques when presenting acceptable identification.

[22] Michael Grant, op. cit., p. 27.

[23] Ekos Research, op. cit., Exhibit 3.4, p. 26.

Agreement on Opening Accounts

In February 1997, the federal government reached agreement with major banks to facilitate access to account and cheque-cashing services for low-income individuals (See Exhibit 3.2). This agreement decreased the number of pieces of identification required to open an account or cash cheques; it ensures that employment and minimum deposits are not conditions for opening an account; and it committed the institutions to train their staff to follow their banks' identification policies and to be sensitive to the needs of low-income individuals. In December 1997, the government and the banks agreed that an unsatisfactory credit report, so long as it did not reflect dishonest or fraudulent behaviour, would not in itself be a reason to deny an account, although it might lead to restrictions on some account activities.

Exhibit 3.2
Access to Basic Financial Services

The following are elements of the understanding reached by the major banks and the federal government:

Only two (decreased from three) pieces of signed identification (ID) will be required to open an account or cash cheques, with photo identification desirable but not mandatory (the Canadian Bankers Association's July 1996 identification requirements provide a list of typically acceptable ID). Sponsorships from responsible customers known to the branch will be accepted.

Bank policies on "holding" or "freezing" deposited funds will be clearly explained to customers.

Employment will not be a condition of opening a bank account.

Minimum deposits will not be required to open a bank account.

Staff will be trained to follow their bank's ID and hold policies, and to be sensitive to the needs of low-income individuals.

Staff will be reminded of the need for all customers to be treated with fairness and respect.

More information and training, developed in conjunction with national and local community groups, will be provided to low-income groups to help them become more knowledgeable and comfortable with using bank services.

Source: Department of Finance Canada, News release, February 14, 1997 (97-012).

The agreement addresses many of the concerns of community groups and social assistance agencies with respect to access. In particular, it forbids the use of an individual's employment status as a reason for refusing an account application. The agreement has been followed up by training programs and other measures aimed at ensuring that practices at the branch level conform to policy. The Canadian Bankers Association has supported these policies by developing pilot projects, and has conducted training programs in areas where the access problem has been greatest.

It is too early to know for certain how well these new measures are working, but there is considerable scepticism that the February 1997 agreement is making a substantial difference. Options Consommateurs has informed the Task

Exhibit 3.3
Experience with the February 1997 Agreement

In February 1998, a research associate employed by the Task Force visited bank branches in Toronto neighbourhoods inhabited largely by low-income residents. He attempted to open accounts at seven branches using a social insurance number (SIN) card, driver's licence and birth certificate as identification. The driver's licence and SIN card were sufficient to open accounts at three branches, but problems were encountered at four others. One bank in Cabbagetown required three of the following: driver's licence, citizenship papers, SIN card, credit card or passport. A birth certificate was unacceptable. The researcher argued that while he possessed a driver's licence and a SIN card, it was impossible for him to obtain either citizenship papers (because he was born in Canada) or a credit card. He further explained that he did not want to spend a lot of money on a passport just to open an account. The customer service representative responded that the only way an account could be opened at that branch was by showing a valid passport, and offered no other suggestion for dealing with the problem.

In the branch of a different bank in the neighbourhood of Jane and Finch, it turned out to be impossible for the researcher to open an account, even though his identification was acceptable, because he informed bank staff that he did not have a phone number. This particular branch required any walk-in applicant to fill out an application form and undergo a credit check before being allowed to open an account. If the applicant passed the credit check, the branch would contact that person by phone to set up an appointment. As the researcher explained that he did not have a telephone, his application was refused. The researcher argued that he needed a bank account but did not want to pay the costs associated with obtaining a phone, and he asked if there was any way that this would be possible. After consulting with the branch manager, the customer service representative suggested trying another bank across the street.

The researcher also carried a federal government cheque, which he attempted to deposit and draw cash from in the banks where he opened an account. Again he encountered mixed results. While some banks had no problem with this transaction, other banks insisted that a five-day hold period was necessary.

Force that its initial follow-up “mystery shopping” survey of financial institutions revealed that there had been only limited progress since the agreement was reached. The experience of a Task Force researcher who attempted to open an account at several branches in low-income neighbourhoods was discouraging (see Exhibit 3.3).

Other Government Initiatives

Governments have also acted to improve access to financial services by establishing alternative forms of identification, entering into indemnification programs with financial institutions, and introducing direct deposit arrangements for social benefit programs.

Alternative identification

Identification is a major obstacle to opening a bank account because individuals with low incomes are unlikely to possess even the types of identification prescribed by the February 1997 agreement (see Exhibit 3.4). This problem has been addressed in some jurisdictions by government action to

Exhibit 3.4

Identification Typically Accepted for Opening Accounts[1]: (as at August 1997)

- Bank/automated banking machine or client card from a well-known, reputable, financial institution
- Credit card with customer's signature, issued by a well-known, reputable, financial institution
- Health insurance card[2,5]
- Passport[3]
- Senior citizen's (OAS) card issued by federal government
- Canadian citizenship card
- Employer identity card from a well-known company with photo/security pass
- Indian status certificate
- Personal reference by known client or staff
- Social insurance card
- Valid drivers' licence issued in Canada[4]

[1] Subject to change; banks will also accept other forms of identification than the above. However, the above are the forms of ID generally accepted by the major banks.

[2] Except in Ontario, Manitoba and PEI where the following legislation prohibits banks from using health cards as identification: Ontario – Health Insurance Act, 1991; Manitoba – Personal Health Information Act, 1997; PEI – Provincial Health Number Act, 1997.

[3] Canadian passports are acceptable. Foreign passports are less desirable since banks may not be familar with each country's passport.

[4] Quebec drivers' licences cannot be requested by financial institutions for identification purposes (Highway Safety Code, RSQ, c. 24-2, S. 61, par. 2).

[5] Quebec health cards cannot be requested by financial institutions for identification purposes (Health Insurance Act, 1991).

Source: Canadian Bankers Association.

establish alternative forms of identification. For example, Alberta Family and Social Services, working with financial institutions, has developed alternative identification arrangements that an individual can use at a specified branch of a financial institution.[24] Other general types of identification have been acceptable to some financial institutions, including the photo identification issued by the Ontario Liquor Control Board and Alberta Registries.[25]

Michael Grant finds that industry acceptance of alternative forms of identification has been mixed. With respect to the identification issued by the Alberta Registries, he observes, "Some institutions have had no problems whereas others are concerned about the due diligence in issuing this identification. Those that are concerned have treated the identification as secondary identification to be supported by two other pieces of identification."[26]

Indemnity agreements

Indemnity agreements between governments and financial institutions can help people gain immediate access to their funds. Under these agreements, a financial institution that meets certain standards with respect to identification when cashing a cheque can be assured of payments from the agency that issued the cheque. Such indemnity agreements differ in their features. Grant reports that the federal government has an indemnity agreement for cheques up to $1,500. This agreement covers an institution only for cashing cheques of non-customers; it does not apply to cheques cashed or deposited by account holders. In contrast, both the provinces of Alberta and British Columbia have indemnity agreements that cover both an institution's customers and non-customers. These agreements eliminate any need for holds on cheques when the institution follows the specified procedures.[27]

Direct deposit

Governments at all levels have undertaken initiatives that improve access to financial services through direct deposit of social benefit payments into recipients' accounts.[28] These initiatives have advantages for both the government and the recipients.

[24] These initiatives need not be confined to government. Social assistance groups in Vancouver have cooperated with financial institutions to provide photo identification for the homeless.

[25] Alberta Registries are private businesses that perform a variety of functions on behalf of the government.

[26] Michael Grant, *Moving to a Mandatory Direct Deposit Scheme,* Research Paper Prepared for the Task Force on the Future of the Canadian Financial Services Sector, Ottawa, September 1998, p. 8.

[27] Grant, *Canada's Social Payment Disbursement System*, op. cit., p. 28.

[28] Ibid., Grant shows the present arrangements for social payment disbursements for federal, provincial and municipal programs in Table 1, pp. 13-15.

From the government's point of view, direct deposit can reduce program costs. These cost savings will be in proportion to the number of benefit recipients who elect to receive direct deposits. Government therefore has a direct incentive to assist people to open an account in order that it may maximize the savings from the use of direct deposits. Some governments have encouraged and assisted clients to open accounts by working closely with deposit-taking institutions.

The movement to direct deposit also benefits individuals. It eliminates lost or stolen cheques and the cost of cashing cheques. No longer do individuals need to wait in line and present identification each time they try to cash their cheques. In addition, their funds will not be placed on hold. Finally, an important advantage is that the process of establishing direct deposit capability can act as a springboard enabling low-income individuals to open an account.

Some people may not want the account needed to receive direct deposits.[29] Generally, the programs will grant exemptions with differing degrees of substantiation, depending on the nature of the claim. Some programs provide attractive options similar to direct deposit for individuals not wanting their own account.[30]

The success of direct deposit arrangements for the payment of social benefits depends on the benefit program. Grant suggests that direct deposit will work better in programs that pay a regular fixed amount to a stable group of recipients. Programs with high use of direct deposit include the Alberta Widows Pension (99 percent), Old Age Security (82 percent), the Canada Pension Plan (81 percent), and family benefits of the Ontario government (83 percent) and Peel County (98 percent).

Approaches to Improve Access

The Task Force believes that the major problems preventing further progress in this area have to do with attitude and culture rather than process. Despite the policy of the banks and some bright spots in actual practice, it appears that there is still a considerable problem on the ground in serving a class of customer that is not likely to be profitable to the branch.

The increasing trend to focus more resources and attention on customers that are profitable is exacerbated by stereotypical attitudes toward individuals with low income. Unfortunately, this is not simply a problem of bank employees'

[29] People may not want an account because they fear seizure of their funds on the basis of a court order, live in remote areas removed from financial institutions or are unable to manage an account. Some do not want the added expense of service charges.

[30] The Metro Toronto pilot project, for example, gives the choice between having the payments deposited to a personal account or using a master account at Metro Toronto's bank. The master account allows people to withdraw cash from it using a personal debit card. Users are allowed three free withdrawals per month and are charged for any additional transactions.

attitudes; at issue are attitudes toward low-income individuals that are found throughout our society.

Recommendations have been made to the Task Force that legislation should grant all Canadians the right to a basic account at an affordable price.

Progress is being made in bringing banks, governments and social groups together to deal with the problems. In the view of the Task Force, because the root cause is attitudinal and cultural, the cooperation of interested groups holds the promise of providing a more effective and durable solution. But this will only happen if such cooperation is effective.

If real progress is not made and seen to be made soon, the Task Force believes that a legislated solution may then be necessary to overcome the cultural and attitudinal barriers that exist.

The balance of this section details some additional steps that should be taken, short of legislation, to improve access.

Provide Accessible Identification

Community groups and the Canadian Bankers Association both recognize the need for more appropriate forms of identification. The recent initiative of the Government of Alberta to provide alternative forms of identification appears to have helped. Further initiatives of this sort seem desirable but should be part of a more general program of alternative identification.

The Task Force has concluded that federal and provincial governments should make low-cost personal identification available to anyone requiring it.

Develop and Publicize Standard Basic Accounts

The Task Force proposes that all deposit-taking institutions offer a standard basic account. Financial institutions, governments and community groups should work together to specify a common basket of services to be part of the account, including a specified number of withdrawals and a debit card.

It is important that target users know that the basic account option is available and how to get one. Beginning immediately, all deposit-taking institutions should post prominently in their branches the terms of their most economic transaction account and the identification requirements necessary to open one.

These accounts should be offered by all deposit-taking institutions. In the case of some credit unions, the need to buy a share to become a member may present an obstacle to opening an account. While in some cases this share costs no more than $5, in others it may cost as much as $100. All credit unions should follow the example of those that allow members to spread their share payments out to make membership more affordable.

Increase the Use of Direct Deposit

The Task Force proposes that governments should increase the use of direct deposit for all government programs that offer regular benefits, using individual accounts or master accounts as is now done in Metro Toronto. Direct deposit provides a mechanism for improving access to accounts and eliminating holds on funds. Every effort should be made to encourage participation in such programs without forcing people to join.

Increase Indemnification

Cheques will not disappear for the payment of government benefits, at least not for a long time. For this reason, governments should follow the lead of the federal government and some provinces by developing indemnity programs with financial institutions. These agreements should cover both the cashing of cheques for non-customers and deposit of funds by customers. Unless they do so, they will not eliminate the need for holds. Moreover, they could discourage individuals from having accounts with financial institutions if the cashing of a cheque over the counter leads to quicker access to funds than depositing it into an account.

Monitor Results Regularly

The Task Force believes that results should be monitored regularly. The federal government should immediately undertake a careful survey of the number of "unbanked" in Canada, both to benchmark the extent of the problem and to understand better the reasons why those persons remain outside the system. Progress toward access should be monitored regularly through mystery shopping and other methods, and the survey should be repeated at regular intervals.

Work to Change the Culture

People who want to hold accounts and perform transactions should be treated with courtesy and respect. Under the February 1997 agreement, financial institutions committed themselves to training staff to follow identification and cheque hold policies, and also to be sensitive to the needs of low-income individuals. Financial institutions should continue to work with community groups to develop and implement staff training programs. Such programs should be reinforced by incentive and compensation policies at the branch level to assure that the agreed policies on access are in fact implemented.

Legislate if Necessary

If progress is not made within a reasonably short time frame, the government should legislate the terms of the February 1997 agreement, with appropriate sanctions for non-compliance.

Availability of Branch Services

Most Canadians still expect to be able to use the services of a branch office despite the increasing use of bank machines and electronic payments. Many Canadians fear that important relationships are increasingly threatened by the prospect of branch closures.

Branch closures have a disproportionate impact on particular groups in society. Until now, they have been primarily a concern of those who live in small rural communities and low-income neighbourhoods in urban centres. The recent merger proposals have raised the sensitivity of most Canadians to the issue.

This section:

- describes the public interest in branch closures;
- discusses the economic pressures leading to branch closures;
- examines the consequences of branch closures for different types of customers; and
- sets out an approach to branch closures that would ease their consequences.

The Public Interest in Branch Closure

A branch office forms an important link between a financial institution and the community it serves. To many customers, it offers personalized banking services with which they are familiar and comfortable. It allows borrowers an opportunity to develop a customer relationship that may be critical, in many cases, to assure a stable source of credit. Increasingly, it serves as a source of advice to investors, whose choice of investment vehicles continues to expand. These relationships are threatened when branches close.

Notwithstanding all the strides that have been made in electronic banking, Canadians clearly value the option of using branches to access financial services. Two of every three people surveyed by Ekos Research agreed that it was important to them to be able to do their banking in person at a branch.[31] Moreover, the elderly and people living in smaller communities were more likely to prefer using a teller to a bank machine.

This dimension of access to financial services raises different issues from those of access for low-income groups. Customers in these communities have already established relationships with financial institutions. The withdrawal of branches forces them to change the way in which they transact their financial business, or the institution with which they deal. The problem posed by branch closures has been highlighted in presentations to the Task Force by groups such as Options

[31] Ekos Research, op. cit., Exhibit 3.2, p. 24.

Consommateurs, the Canadian Community Reinvestment Coalition and the National Council of Welfare.

The closing of branch facilities by financial institutions raises two policy issues:

- Should government intervene in business decisions to open or close service locations?

  In some jurisdictions in the United States, the opening and closing of bank branches is subject to approval or is taken into account in the bank's assessment by regulators. Canadian policy, on the other hand, has left branching policy – both opening and closing – to the discretion of the institutions. Any movement toward requiring regulatory approval of branch closing would represent a substantial departure from current policy. Nevertheless, such a change would appear to have public support. Only 31 percent of Canadians agreed, and fully 56 percent disagreed, that banks should be able to close branches as long as customers can still get access to services through new technologies.[32]

  Such a departure would raise fundamental questions. Few other business enterprises face a responsibility to maintain services in a community. Is there something special about financial services and their providers that requires them to maintain service or to require approval to discontinue service? There may be better alternative ways for obtaining financial services from a distance than for many other essential goods and services such as gasoline or groceries. Yet the closure of gasoline stations and grocery stores is not regulated.

- Do financial institutions closing branch facilities and/or governments have a responsibility to ease the transition difficulties for the affected community?

  Many costs of branch closures may be unavoidable, but the abrupt removal of services may aggravate the consequences. If financial institutions give adequate notice and work with the community, together they may be able to provide alternatives. Even in the absence of replacement facilities, customers and the communities in which they live may be able to better manage the adjustment with adequate notice. Borrowers may be able to shift their lines of credit to other institutions while there are still local branch staff who can vouch for them from their experience. Notice will also allow employees the time they need to plan and adjust to change.

  The financial institution itself is uniquely placed, by its expertise and its knowledge of the customers and their history, to facilitate these adjustments to branch closures. The burden of adjustment on the community could be lightened through the cooperation of the financial institution.

[32] Ibid.

The Pressures on Branches

The public interest in branch closures appears much higher than in the past, perhaps reflecting a perception that branch closures will become more frequent in the future. A number of forces are threatening the continued existence of many branches:

- Population shifts out of many rural areas are reducing the customer base of branches in small towns and making them less and less economic to operate.
- Household deposits have declined as a share of household financial assets, from 34.1 percent in 1980 to 25.1 percent in 1997.[33] In addition, the level of personal savings deposits at chartered banks has shrunk by 4 percent since its peak in April 1996.[34] Fewer deposits make branches less economic.
- Customers now have greater choice with respect to the channels through which they use banking services. Data prepared for the Task Force by McKinsey & Company show that the use of point-of-sale payments grew by 101 percent per year between 1992 and 1997, and that of telephone banking by 50 percent per year between 1994 and 1996.[35] They also show that branches accounted for only 38 percent of retail transactions in 1995 and are expected to account for only 21 percent in 1998. Transactions at bank machines are expected to be almost double those at branches in 1998.
- Branches are costly channels for servicing the needs of customers. A U.S. study estimates that a typical branch occupies 5,000 square feet and costs $1.4 million a year to operate. These non-interest costs equal 2.8 percent of deposits for a branch with $50 million in deposits. This margin compares with the typical expense ratio of money market funds of between 0.5 and 1 percent.[36]
- The high costs of branches are increasingly a disadvantage for incumbents compared with new competitors that offer banking services through less costly methods. Already ING and Citizens Bank offer retail deposit services without the use of branches. In order to compete with new entrants, financial institutions will be trying to reduce costs by shifting their customers toward less costly types of service.

These pressures are changing the role of branches in the delivery of retail banking services. Many branches are being converted from their traditional roles, which emphasized over-the-counter deposit transactions services, to advice-intensive

[33] See Background Paper #1, *Competition, Competitiveness and the Public Interest*, Exhibit 2.5

[34] See Bank of Canada Review, Table C2, Series B451.

[35] McKinsey & Company (McKinsey), *The Changing Landscape for Canadian Financial Services: New forces, new competitors, new choices,* Research Paper Prepared for the Task Force on the Future of the Canadian Financial Services Sector, Ottawa, September 1998, Exhibits 3.5 and 3.6.

[36] Daniel K. Orlow, Lawrence J. Radeck and John Wenninger, *Ongoing Restructuring of Retail Banking*, Federal Reserve Bank of New York, Research Paper #9634, pp. 3, 4.

businesses, focussing on the needs of customers in managing their personal and business affairs. These branches are perceived by the banks to be important to their future business success because they will provide a focus for face-to-face relationships with their customers.

But in more marginal branches this change of function will not be commercially practicable. Some of these branches may continue in a scaled-down or modified way. Limited service branches and kiosks in supermarkets, agencies and post offices, retail stores, and mobile banking facilities all provide ways in which services may be provided, or in which the relationship developed through branches can be preserved at a lower cost. Still, many conventional branches will be threatened by the pressures.

The Consequences of Branch Closures

As technology changes the delivery of financial services and as population shifts from rural areas, banks and other financial institutions have closed branches in both lower-income urban neighbourhoods and smaller communities. Exhibit 3.5, based on data compiled by the Task Force staff, shows that 122 communities lost their only bank branches over the period from 1991 to 1996.[37] One community lost all three of its branches, two communities lost their only two branches and 119 communities lost their sole branch.

Exhibit 3.5
Number of Communities that Lost Bank Branches Between 1991 and 1996, by Region

	Number of Branches in 1991					
	Three			Two		One
Number of Branches in 1996	**Two**	**One**	**None**	**One**	**None**	**None**
Alberta	1	1		1		10
British Columbia				1	1	4
Manitoba	1					8
New Brunswick		1		1		4
Newfoundland		1		1		5
Nova Scotia						7
Ontario			1	3		28
PEI						1
Quebec	4			2	1	12
Saskatchewan	3			5		40
Total	**9**	**3**	**1**	**14**	**2**	**119**

Source: Canadian Payments Association, *Canadian Payments Directory*, vol. 1 (Banks)

[37] The information is based on place names listed in Canadian Payments Association, *Canadian Payments Directory*, vol. 1 (Banks).

For some customers, the costs of losing banking facilities may be only transitory. They will need to adjust their banking habits away from using facilities within a branch to using a bank machine, or carrying out transactions over the Internet or through telephone banking. For others, the costs may be permanent. Some people may find it difficult to cope with new technologies; those with low income may lack access to these technologies; and customers with a need for personal attention and advice may suffer a permanent decline in service.

SMEs have traditionally relied on a customer relationship through a branch in order to access credit. This relationship worked both ways: it provided the lender with information needed to approve credit and to monitor the quality of its loans, and it provided customers with assistance in managing the businesses that sustained their ability to borrow. In the absence of this personal contact, small businesses may be concerned that lenders will be more likely to act arbitrarily, to their detriment. Electronic banking and the use of credit scoring techniques may alleviate this problem for some borrowers, particularly those that have a strong performance record and credit history. Lack of a customer relationship with a branch will be most costly to start-ups and other very small firms, whose financing problems are discussed more fully in Chapter 4.

For some communities, the loss of their last branch will be even more threatening. The branch may have been the community's source of the currency and coin needed for everyday business. Without the branch, businesses may have to travel long distances to make deposits or withdrawals. Such transfers of large amounts of currency expose businesses to new and greater security risks.

In some communities, the loss of a branch may be traumatic for reasons beyond the economic costs. It may be seen as just a further sign of the continuing erosion of the infrastructure that supports the community as a community. While these costs may never be avoided, a process that respects the community and its needs may soften the blow.

Policy toward Branch Closure

Current government policy with respect to branch closing carries no obligations for deposit-taking institutions other than the need to inform customers of the location to which their accounts have been transferred.[38] Some financial institutions have made substantial efforts to ensure the continuation of some form of financial services in the community. For example, some banks that have closed branches are reported to have allowed credit unions to use the former branch premises rent-free for a period of time. Overall, the present approach appears haphazard, with different arrangements at different times and places.

[38] A review of the Bank Act, its regulations and guidelines of the Office of the Superintendent of Financial Institutions (OSFI) does not indicate any restrictions on branch closings. The CBA also reports that the banks have not established an industry policy with respect to branch closings.

The loss of a branch facility may be eased in many ways. Alternative institutions could enter the market to fill the gap; customers may learn new ways to access financial services; and borrowers may be assisted in forming new relationships with lenders. Banks may establish agency relationships to facilitate "part-time" branches or, as some banks now do, may schedule regular visits by bankers to small communities not served by a branch. It is very difficult to prescribe the measures needed in each instance because of the differences between communities. A farming town in Saskatchewan has very different needs from an outport in Newfoundland or the Regent Park area of Toronto.

Still, all these measures may take time. We believe that the transition could be eased through cooperation between the financial institution, local governments, and local organizations such as chambers of commerce or service clubs. With adequate notice, these groups together could search for and encourage replacement institutions. The community would have the opportunity to explore the possibility for a local business or post office to serve as an agency for a financial institution, offering limited services to replace the branch. They could also run programs to educate consumers about using different banking techniques, and to assist local businesses in establishing new relationships for their financial services.

While the closing of urban branches may present very different problems from rural closings, a similar strategy might be useful. Some urban closings may occur in low-income communities. Here many of the customers will find it difficult to adapt to new technologies and feel uncomfortable with using other branches. In some cases, customers might best be served by transferring their business to branches of different institutions. Financial institutions planning to close branches might work with local community organizations to assist customers in re-establishing their financial arrangements in new outlets.

The Task Force does not believe that it would be appropriate to strip banks of the ability to close their branches or to subject such closures to regulatory approval. However, the Task Force believes that the need for time to adjust is so vital that financial institutions planning to close branches should be obliged to give reasonable notice to relevant stakeholders. Such notice should be provided at least four months in advance of the closing date. This notice should be posted prominently in the branch, communicated to all customers and relevant local authorities, and published in community newspapers. The Task Force expects that the notice would provide the time for financial institutions to work with local government, community organizations and other financial institutions to assist in developing alternatives that minimize the disruption caused to customers by closure.

Such notice should be a requirement for all federally regulated deposit-taking institutions. The Task Force urges provinces to consider a similar requirement for provincially chartered deposit-taking institutions.

The government should regularly monitor performance and review whether additional measures might be necessary.

Availability of Micro-Credit

The Task Force is impressed by the potential social and economic benefits from micro-credit programs. The Task Force believes that both governments and financial institutions can make productive contributions to the development of micro-credit programs.

This section:

- examines the nature of micro-credit;
- discusses the current state of micro-credit in Canada;
- describes the social and economic contribution of micro-credit; and
- suggests ways in which governments and financial institutions could support micro-credit programs in the community.

What is Micro-Credit?

Micro-credit, broadly speaking, refers to small loans made to individuals to sustain self-employment or start up very small business enterprises. There is no standard definition of micro-credit. People most familiar with it suggest that loans rarely exceed $7,000.

Traditional lending institutions serve part of the micro-credit market. Many small businesses are financed through the balance on the proprietor's credit card. The micro-credit market is not usually served by traditional institutions even though they provide small loans. More than 300,000 customers of major banks had lines of credit of less than $25,000 at the end of September 1997, with an average credit line of only $8,000 for this group.[39]

Many micro-businesses are left unserved because of the difficulties of making micro-loans through traditional channels. The costs of monitoring and assessing hundreds of small loans simply outweigh the returns. Moreover, the individuals standing behind micro-enterprises are often considered "unbankable" in the traditional sense. Many lack collateral and have no credit history.[40]

[39] Canadian Bankers Association, *Business Credit Statistics*, September 1997, p. 13.

[40] A common source of micro-credit is friends and family. Many low-income women and members of minority groups do not have access to the informal networking opportunities that will put them in contact with "angels." This is a reason why programs designed to increase micro-loans often target those two groups.

Others have poor credit records and employment histories. Any micro-loans to these individuals must be made on the character of the borrower. Exhibit 3.6, outlines the typical profile of individuals requiring micro-credit and their financing and technical assistance needs.

Exhibit 3.6

General characteristics of enterprises served	Financing needed	Technical assistance needed
• Informal, part-time, home-based activity	• Start-up or seed capital loans	• Basic business management skills
• Enterprise formation stages	• Small, short-term working capital loans	• Personal development or support • Verbal "action plan"
• Entrepreneur is beginning to think of home-based activity as a business		• Intuitive understanding of break-even volume

Source: Derived from Shorebank, *Survival of the Fittest* (1992)

Micro-Credit in Canada

A number of micro-credit programs have been established across Canada over the past 10 years to serve people who cannot get micro-loans from financial institutions. These programs are usually sponsored by private organizations.[41] Micro-financing is also available from some federal government programs, including the Atlantic Canada Opportunities Agency (ACOA), Human Resources Development Canada, Industry Canada's Aboriginal Capital Corporations and the Business Development Bank of Canada (BDC). Some provincial governments also provide micro-financing.

While their purposes are similar, each program has its own distinctive features. Some rely on "character lending," where credit is awarded on the basis of the character of the borrower. Others use the "peer group" approach, where borrowers form small support groups and vouch for each other's loans as a substitute for collateral. Micro-credit programs are often part of broader programs under which people trying to start a business receive basic management skills and other forms of support. While many programs have been successful in making and gaining repayment of micro-loans, none appears to be profitable.[42]

[41] Results Canada lists 21 micro-loans funds in Canada. See their Presentation to the Task Force, October 9, 1997.

[42] In fact, the Organization for Economic Co-operation and Development (OECD) in its report *Micro-credit in Transition Economies* (Paris: OECD, Centre for Co-operation with Economies in Transition, 1996), p. 17, indicates that currently there are "no North American micro-credit organizations that are earning a profit or currently covering all of their costs."

Financial institutions such as banks or credit unions have been involved as sources of loan capital or administrative support for a number of the micro-lending programs. Vancouver City Community Credit Union now operates a peer lending program in house, using referrals from branch staff. Several of the banks support foundations that are geared toward the provision of micro-credit. An example is Calmeadow.

The market for micro-credit in Canada is not well understood. Under any circumstances it would be extremely difficult to determine how well such a fragmented market is served. But there have been few studies that have addressed the micro-credit market in Canada and there is a lack of data on this segment of the market. Currently, a group of governmental agencies together with the Canadian Bankers Association are examining the rural micro-credit market.[43] The project's purpose is to determine the unfilled demand for micro-credit and to suggest possible policy measures.

The Contribution of Micro-Credit

The micro-credit market can make an economic and social contribution in the following ways:

- *Job creation*: Micro- and small businesses are important creators of new jobs in the economy. Policies that reduce obstacles to the formation and sustaining of micro- and small businesses, therefore, should contribute to job creation.
- *Social benefits*: Some micro-credit schemes are directed toward people who are currently unemployed or on welfare. Advocates see micro-credit programs as having the potential to reduce poverty and social disenfranchisement. As a result, in addition to any private benefits, there is a social benefit from the savings on social programs by moving individuals to self-sufficiency.

Micro-credit programs should not be seen as social rehabilitation programs in themselves. Rather they are a piece of the puzzle to getting micro-businesses going and allowing them to grow. Increasingly, policy makers appreciate that the provision of capital is necessary, but not sufficient, for moving people off social assistance. In many cases, micro-credit has been one element of broader programs directed toward helping individuals become self-sufficient. Even where micro-credit has been the focus, provision has usually been made for mentoring, peer support and other forms of assistance.

While micro-credit may be most appropriate for only a narrow group of people, it should be recognized that the potential exists for enterprises to become successful SMEs. The successful use of micro-credit, however, requires basic

[43] The participants in the study are Industry Canada, Indian and Northern Affairs, ACOA, Western Economic Diversification (WED), Agriculture and Agrifood Canada and the CBA.

business skills and a feasible business proposition.[44] Without these, the use of micro-credit may be inappropriate and could make things worse for the borrower.

Supporting Micro-Credit

The Task Force recognizes the contributions made by micro-credit programs in assisting individuals unable to gain credit from other sources. Micro-credit has helped these people set up and build their businesses and become self-sufficient. The Task Force believes that there is scope for the productive expansion of existing micro-credit programs and the support of new programs.

The success of micro-credit programs reflects a combination of vision, initiative and commitment on the part of their sponsors. Any assistance must take into account the substantial differences between micro-credit programs. One sponsor observed that, although no program now has the right formula for micro-credit, each program is trying in its own way to find it. The types of support needed will differ from program to program and from community to community.

Government's Role

Experience from around the world suggests that national, or even provincial, governments are not well suited to serve this market directly. Micro-credit is very much a hands-on activity dependent on community contacts and knowledge to identify people who could benefit. However, governments can support and promote micro-lending in a number of ways:

Assistance with start-up and capital costs

Sponsors of micro-loan funds estimate that a well-developed program will have operating costs in the range of about 25 percent of their outstanding balances. While many successful micro-lending institutions operate on donations from local businesses and foundations, there is a sunk cost before any micro-loan program can even begin.

The Task Force believes that it will be in the public interest to provide basic overhead support to micro-lending programs that can demonstrate soundly based micro-loan plans and are unable to secure financing elsewhere. Industry Canada could be considered as a possible source of this funding.

Any federal funding provided to a micro-loan fund should be used only to cover the start-up and overhead costs and not to fund loans themselves. It has been demonstrated that the need for loans to be repaid, and not forgiven, is a

[44] The Community Opportunities Development Association of Kitchener, for example, does not view its seed loan program as part of its core program for developing business skills. Graduates from the core program are not encouraged to use the loan program immediately. The loan program is directed, instead, at individuals who have demonstrated their ability to run a business.

source of discipline that is an important factor in the success of the enterprise. Local governments and foundations may be best able to judge whether their community can support a successful micro-credit organization. They can signal their commitment through providing the loan fund.

Adjusting benefit programs

Some provinces accommodate recipients of social assistance who are also receiving credit to start a small business by allowing them to continue receiving their benefits for a period of time. Other provinces require people receiving benefits to count micro-credit loans as income, thereby reducing their social assistance benefit. This approach discourages people from taking loans and is seen as a substantial obstacle to effective micro-credit programs. The Task Force urges provinces to ensure that their benefit programs do not create disincentives for individuals seeking micro-funding to start up a new business.

Many people think that micro-credit will jeopardize the benefits they receive even if government programs do not penalize those receiving micro-credit. To overcome this perception, provincial governments should ensure that their caseworkers are well informed and that they give appropriate advice to their clients.

Supporting communication and cooperation

The Task Force has heard success stories about micro-loan funds operating in many regions of Canada. It has also been impressed with the diversity of approaches taken, and by the commitment and ingenuity of the sponsors. Unfortunately, there is only limited contact between the various micro-credit institutions. The Task Force believes that those associated with micro-credit programs could learn from sharing their experiences – both successes and failures – with each other. These experiences should also help communities planning micro-credit programs of their own.

The Task Force encourages Industry Canada to foster communication and cooperation among micro-credit organizations. It could help sponsor conferences such as those held by the Montréal Community Loan Association on community loan programming.[45] Industry Canada could also support an industry newsletter or Web page devoted to micro-credit. Its Strategis Web site already has links dealing with small business issues and would be a good forum for such a Web page.[46]

[45] The Association has organized two annual conferences and is planning a third for the fall. Last year's conference was attended by over 100 individuals interested in community credit programs.

[46] The address of the Strategis site is http://strategis.ic.gc.ca.

Support from Financial Institutions

Financial institutions are already active in the broad market for micro-credit. They are not active, however, in the market segment served by micro-credit programs whose clients fall short of the standards for commercial credit. This does not mean that these institutions cannot play a constructive role. The Task Force feels that financial institutions can contribute to strengthen the market for micro-credit in a number of ways.

Assisting in communication

Public awareness of micro-credit programs is essential to their success. At present, it appears difficult to find out about existing micro-credit programs. There seem to be organizations prepared to make micro-loans, on the one hand, and micro-enterprises seeking these loans, on the other. Some loan funds have indicated to the Task Force that their biggest constraint is finding clients for their programs.

Many clients served by micro-credit programs have been repeatedly turned away by the traditional lending institutions. They are not easily reached by traditional means. Micro-lending institutions need to develop creative and innovative ways of reaching these people.

Micro-credit programs would be helped by an efficient referral system through which potential clients who have been turned down by traditional lending institutions are directed to micro-lending institutions. Such a referral system would be fully consistent with the banks' Code of Conduct for small and medium-size businesses, which requires loan officers to tell customers refused credit about alternative sources of financing.[47] The Task Force urges the banks to encourage employees to adhere to this code and inform customers about micro-credit programs where appropriate. Other lending institutions should adopt similar codes and ensure that their loan officers follow them.

Partnerships

Banks and other financial institutions have expertise and other resources that could support micro-credit programs. The benefits of these assets could be shared with micro-credit programs through the development of partnerships between branches and the micro-credit programs in their local communities.

[47] Recent evidence suggests compliance with this code is limited. A 1998 study showed that only 4 per cent of small and medium-size firms that were turned down for a bank credit recalled being informed of alternative sources. This result is consistent with anecdotal evidence from micro-credit programs about their experience with referrals. It should be noted that the same survey found 61 percent of account managers reported that they had suggested alternative sources of financing. See Thompson Lightstone & Company, *Small and Medium Sized Businesses in Canada: An Ongoing Perspective of Their Needs, Expectations and Satisfaction with Financial Institutions*, 1998, vol. 1, p. 99.

Through these partnerships, employees of financial institutions could share their experience in evaluating business plans and proposals. In addition, financial institutions could provide the administrative support to handle and record disbursements and repayments made under the programs.

The Task Force also believes that financial contributions to micro-credit programs is an appropriate area where financial institutions can direct their community support. Other institutions could follow the lead of Vancouver City Community Credit Union by developing their own micro-credit programs. Financial institutions are also well placed to identify micro-credit programs that can use these resources most productively. The Task Force urges financial institutions to develop further these types of partnerships with micro-credit programs.

Partnerships with the Voluntary Sector

The Task Force received a submission from the Voluntary Sector Roundtable (VSR), which outlined a number of ways in which the financial sector could work more closely in partnership with the voluntary sector in Canada.[48]

The VSR is an unincorporated group of national organizations and coalitions that came together in 1995 to strengthen the voice of Canada's charitable, voluntary sector. The voluntary sector is indispensable to the ability of society to address community needs. It plays a critical role in strengthening communities and, in light of reductions in governments' role, its importance is increasing. The financial services sector is very community-minded and major institutions have been among the most generous donors of money, time and energy in assisting the voluntary sector.

The issue raised in the VSR submission is whether it is possible to look beyond traditional activities to the development of new, innovative partnerships that would help build stronger, healthier and more caring communities. The VSR identified a number of issues and opportunities that the Task Force believes are worth exploring further. For example:

- As electronic commerce reduces the need for cash, will contributions to charities relying on cash donations diminish, as there is less cash in the system? Should electronic bill payment options include the option of making donations to charities electronically?

[48] Voluntary Sector Roundtable, *Presentation to the Task Force on the Future of the Canadian Financial Services Sector*, April 8, 1998.

- Can financial service products be linked to donation mechanisms to provide even more choice to consumers? For example, the introduction of "ethical" mutual funds by the credit union movement has been very successful. In the United States, the concept of a "shared return mutual fund," where mutual fund holders allocate a percentage of their annual income as a donation to sponsoring charities, has been implemented. A similar concept is "shared interest accounts," where a percentage of interest income is automatically passed to designated charities as a contribution. Citizens Bank offers both a savings account and mortgages with similar properties.
- Are there opportunities for "top-up" options, whereby small dividends to individual investors (e.g., less than $2) would automatically go to charities? The ability and willingness of financial institutions to administer programs like this could be very meaningful in the aggregate. A variation would be to explore whether Interac payments could be rounded up to the next dollar, with the difference flowing directly to charities.

There are many more opportunities like this discussed in the VSR submission.

The Task Force believes that this is a particularly important time for leaders of financial institutions to explore with leaders of the voluntary sector how new ways of serving Canadians can be developed. The Task Force hopes that conversations among the leaders of the two sectors could begin, with government assistance if necessary, to flesh out pilot projects for quick implementation. While the Task Force believes that action should come from leaders of the voluntary and financial sectors, the Government should consider sponsoring a round table to discuss the issues, problems and opportunities, if this would be helpful to launch the process.

Finding ways of not only meeting but exceeding community expectations would be beneficial for communities as well as for the institutions.

Investment in Communities

The Community Reinvestment Act in the United States requires banks to satisfy the service and credit needs of the communities where they are located, in a manner consistent with the safe and sound operation of the institution.[49] It operates by disclosure by banks of lending, investment and service activities within communities including credit granted to small businesses. Regulators grade banks' efforts and the results are made public. Regulators take performance into account when permission is required to undertake major transactions or to change powers or structures.

49 Canadian Community Reinvestment Coalition, op.cit., p. 14.

Suggestions have been made that Canada should adopt an accountability framework similar to the CRA.

Allan Riding, in his study for the Task Force, points out that apparent widespread discrimination against low-income communities provided the basis for the mandated disclosure under the CRA:

> The genesis to the CRA in the U.S. was the perception of *redlining* that institutional lenders discriminated against low-income communities. The hearings that accompanied the legislation received testimony about how some institutions denied loans to members of poor inner-city neighbourhoods, yet used their deposits to make loans to inhabitants of more affluent neighbourhoods.[50]

Riding goes on to quote Senator William Proxmire, the sponsor of the CRA in the U.S. Congress:

> By redlining … I am talking about the fact that banks and savings and loans will take their deposits from a community and instead of reinvesting them in that community, they will invest them elsewhere, and they will actually or figuratively draw a red line on a map around the areas of their city, sometimes in the inner city, sometimes in the older neighbourhoods, sometimes ethnic and sometimes black, but often encompassing a great area of their neighbourhood.[51]

It has not been established, and it does not appear, that similar conditions warranting such a mandatory approach exist in Canada at this time. Such an approach would entail an onerous review process that would require the definition of relevant communities, the development of appropriate standards of behaviour, and regular, intensive monitoring. It would add substantial regulatory burdens and costs. For these reasons the Task Force does not believe that a full-blown CRA approach should be introduced in Canada.

The Task Force does recognize, however that there are legitimate public expectations that banks and, increasingly, other financial institutions will invest in the communities in which they do business, in a manner that is consistent with prudent business considerations. The Task Force is proposing (see Chapter 4) that a mandatory disclosure regime for small business lending be introduced to broaden, strengthen and codify in legislation current reporting practice. That regime, accompanied by the annual Parliamentary review which the Task Force also proposes, will provide a public forum for dialogue on the performance of financial institutions. Focussed, open dialogue is essential to enhance the relationship between institutions and communities.

[50] Allan Riding, *Financing Entrepreneurial Firms: Legal and Regulatory Issues,* Research Paper Prepared for the Task Force on the Future of the Canadian Financial Services Sector, Ottawa, September 1998, p. 32.

[51] Ibid., p. 32.

Community Accountability Statements

The Task Force also urges financial institutions to make every effort to ensure that their actions work to enhance the quality of life in the communities they serve, and that they communicate to these communities, in a regular and public way, the positive and constructive role they are playing. A healthy financial sector that serves Canadians well will be one in which financial institutions are regarded with trust and respect, and where they are welcomed as contributors to a better quality of life for Canadian communities.

The Task Force recognizes that financial institutions today make a significant difference to the lives of Canadians, and that all of us would be poorer without the contribution these institutions make. But whether or not financial institutions are doing enough, there is no commonly accepted way for them to report on their performance in order to provide a basis for discussion with the public on community needs and expectations.

As an important step in improving the relationship between financial institutions and the communities they serve, the Task Force proposes that all federally regulated deposit-taking institutions and life insurance companies should be required to produce annually Community Accountability Statements. Provincial governments should consider similar requirements to apply to financial institutions within their jurisdiction.

The Community Accountability Statements would inform the public of the institution's contribution to the community through activities such as:

- investment in community development or corporate philanthropy;
- their support of community activities and their partnerships with the community;
- the participation of their employees in community service;
- the employment that they provide and the taxes that they pay to all levels of government; and
- any other issues that may be relevant.

They should also identify emerging community needs to which they intend to respond.

The format and content of these statements should be left to the institution to determine. Each institution should itself define the community or communities it serves in terms of how it chooses to present information. Institutions should report in a manner that would allow Canadians in all regions of the country served by the institutions to be able to relate the information to circumstances relevant to them.

Institutions should make these reports publicly available through their retail outlets and electronically. They should file them with the Minister of Finance who would table them with the House of Commons Standing Committee on Finance.

Chapter 4

Public Expectations and the Financing of Business

This chapter deals with the performance of financial institutions in meeting public expectations about the financing of SMEs and enterprises in knowledge-based industries (KBIs).

Financing SMEs and KBIs is, and should continue to be, a profitable business for banks. As convergence within the financial sector continues, it should become an increasingly profitable business opportunity for other financial institutions as well. It is a business opportunity with a difference, however, since it has attracted and will probably continue to attract community interest and concern about whether levels of activity are "adequate."

The strong public interest in the financing of SMEs and KBIs reflects their importance to the economy and their particular financing problems. The employment and output of SMEs and KBIs have been growing faster than the rest of the economy for more than two decades. These businesses face financing problems that are not shared by larger national and international enterprises. SMEs typically have few options for financing, leaving them vulnerable to the decisions of a few suppliers, and sometimes just one. The main assets of KBI firms are their people and their ideas. They do not have the physical assets used as security by traditional businesses.

This chapter deals with:

- the financing of SMEs;
- some issues related to financing aboriginal businesses;
- the financing of knowledge-based industries; and
- the need for greater information about, and rigorous analysis of, these financing issues.

The Financing of Small and Medium-size Businesses

The financing of SMEs is not a new public policy concern. Many government bodies and others have studied this issue through the past decade, with four separate government committees and Task Forces issuing major statements or reports in 1994 alone.[52] This attention reflects public expectations about the importance of SMEs and their financing needs.

The financing of SMEs is a subject far broader than the mandate of the Task Force, and the participation of financial institutions in this market has already undergone extensive study and analysis. The Task Force commissioned research that reviewed the many studies undertaken and provided an assessment of outstanding issues.[53] In that context, the Task Force has focussed its attention on a few specific but important issues.

This section deals with:

- the basis for the public interest in financing SMEs;
- the current state of SME financing;
- the relationship between financial institutions and SME borrowers;
- the credit experience of SMEs in the 1990s;
- the changing environment for SME financing; and
- approaches to strengthening the relationship between financial institutions and SMEs.

The Public Interest in the Financing of Small and Medium-size Business

What are Small and Medium-size Enterprises?

There are many definitions of SMEs based on measures such as employment, sales and assets. This chapter adopts the common definition that SMEs are firms with fewer than 100 employees or with annual sales of less than $5 million.[54] This covers a range from lawyers, physicians and other professionals through the newest retail shop staffed by its sole proprietor, to innovative enterprises operating at the frontiers of knowledge. Such businesses share the feature that their financing options are typically confined to those found in local or regional markets.

[52] See footnote 12, p. 17 of this paper.

[53] Riding, op. cit.

[54] This contrasts with the approach of Thompson Lightstone, a firm that surveys SMEs attitudes and experience regarding financing on behalf of the Canadian Bankers Association. They treat small and medium-size businesses as those “having annual sales or revenues of $50 million or less and having fewer than 500 employees”, op. cit, p. 1.

SMEs are widespread throughout the economy. Indeed, in Canada in 1996, firms employing fewer than 100 workers amounted to 99 percent of all businesses operating in the country.[55] Viewed from this perspective, it is easy to understand why it is so difficult to come to hard conclusions about SME financing. The size of the sector, the variations among the many firms of which it is composed, and data limitations make it difficult to draw meaningful conclusions. In particular, because the data on financing do not lend themselves to easy disaggregation into meaningful subgroups, there is no clear statistical base that can be used to examine financing issues of particular categories of SMEs.

This chapter attempts to draw some conclusions about the smaller companies and about those that are particularly knowledge-intensive. Moreover, it addresses some special concerns with respect to the financing of aboriginal businesses. But the Task Force's major concern is that the available data be improved to allow more meaningful future analysis of financing issues faced by particular types of firms in this important sector.

Concern about SME Financing

The concern about the financing of SMEs reflects the importance of these enterprises in terms of employment and output, as well as their vulnerability in terms of funding.

In 1995, SMEs accounted for 39 percent of employment in the Canadian economy.[56] SMEs have also been the important generators of employment growth in the economy. Research shows that both gross and net job creation rates are higher in smaller than in larger firms, with most gains in employment coming from newly established firms.[57]

SMEs face limited financing options. Unlike larger enterprises, most of them cannot easily raise funds through public equity and debt markets. For larger businesses, financial markets are national or even global in scope. Many SMEs may have a relationship with only one financial institution, often a bank.[58] Others may have more relationships: a line of credit with a bank, a lease with a specialized finance company or equity from a venture capital firm. Even for these SMEs, however, access to external financing depends on developing and maintaining solid relationships with the suppliers of that financing.

[55] Derived from Chantal Lagacé, *Small Business Primer: The Majority of Canada's Business are Very Small*, Canadian Federation of Independent Business (CFIB), April 1997.

[56] Statistics Canada, *Employment Dynamics*.

[57] G. Picot, J. Baldwin and R. Dupuy, "Small Firms and Job Creation – A Reassessment," *Canadian Economic Observer*, January 1995, pp. 3.1-3.18.

[58] Thompson Lightstone report that 86 percent of SMEs had approached only one financial institution for financing in the past, op. cit., Vol. 1, p. 54.

SMEs have traditionally relied on banks as their primary source of credit. Dealing with SMEs is a profitable business for the banks, with an estimated return on equity of 10 to 15 percent.[59] But lending to them is a business that is inherently difficult. The initiation of loans to small businesses, particularly start-ups, entails a great deal of time and analysis. Putting together a small business portfolio with reasonable risk requires careful tailoring to protect an institution from overexposure to particular sectors or geographic areas. Financial institutions therefore must work very hard to be successful small business lenders.

Because of the characteristics of the SME population, which includes many very small, very young firms that often have no track record, no adequate business plan and untested management, SMEs pose particular problems for lenders. Analysis shows that, relative to other firms, SMEs will be:

- less likely to apply for financing[60];
- less likely to borrow from banks[61];
- less likely to have adequate equity[62];
- more likely to require guarantees for their loans[63];
- more likely to have higher rates of loan loss[64];
- more likely to pay higher interest rates on their loans[65]; and
- more likely to be turned down on loan applications.[66]

For these reasons, small businesses have typically had difficulty in accessing bank financing, not only in Canada but in other countries as well. As Allan Riding points out, "The difficult relationship between lenders and some small business borrowers is not specific to the Canadian setting. Several of the concerns raised by bank clients may reflect systemic issues…. Complaints registered in the U.K. are similar to those expressed in Canada."[67]

[59] McKinsey & Company, op. cit., Exhibit 2.3.

[60] Thompson Lightstone, op. cit., vol. 2, Table A7.

[61] Ibid., vol. 2, Table A5.

[62] CFIB, *Credit Where Credit is Due: Result of CFIB Survey on Credit Conditions in the Small and Medium-sized Business Sector*, January 1998, Figure 3.

[63] Thompson Lightstone, op. cit., vol. 2, Table A13.

[64] CBA, *Business Credit to Small, Medium and Large Borrowers: Specific Provisions in the Canadian Portfolio*, 1996 and 1997. The result is less clear for 1995.

[65] CFIB, op. cit., *Credit Where Credit is Due*, Figure 8.

[66] CFIB, Ibid., Figure 9; Thompson Lightstone, op. cit., vol. 2, Table A14.

[67] Riding, op.cit., pp. 22, 23.

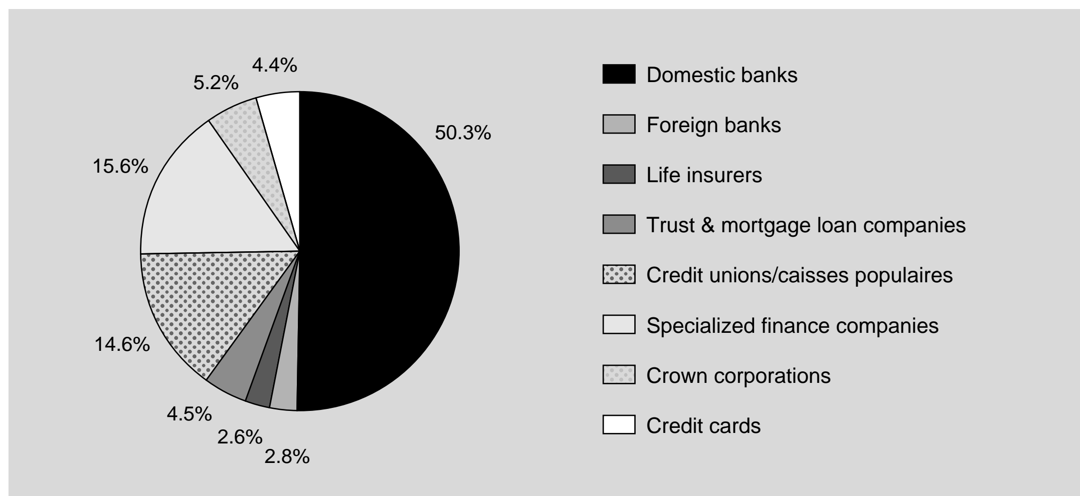
In assessing how well SMEs in Canada are served by financial institutions, McKinsey concluded: "Overall, in terms of pricing, quality, choice, and accessibility, Canadian small businesses receive only fair to slightly below fair service. The thorniest issue is access to credit given the absence of a more developed non-bank, sub-prime lending market."[68]

The Current State of SME Financing

Debt Financing

Canadian chartered banks clearly dominate the debt financing of SMEs. As shown in Exhibit 4.1, they account for over 50 percent of SMEs' outstanding debt, more than three times the share of any other group. Exhibit 4.2, which breaks down the debt financing numbers in Exhibit 4.1 by category, shows that the Canadian banks are even more important as suppliers of commercial loans, accounting for more than 59 percent of the total. Other major players are the credit unions or caisses populaires and specialized finance companies. The relatively large share of cooperatives reflects, in particular, the significance of the caisses populaires as lenders to SME business in Quebec. The specialized finance companies include firms such as G.E. Capital and Newcourt Credit Group. The recent growth in the importance of specialized finance companies has been especially rapid, increasing from just 9 percent to 15.6 percent of SME debt in the years from 1994 to 1996.

Exhibit 4.1
SME Business Debt Financing-Relative Market Shares
1996 total value $110.9 billion



Source: Catherine Moser and Pierre Vanasse, *What's New in Debt Financing for Small and Medium-Sized Enterprises*, The Conference Board of Canada, 1997, Chart 10, p. 28.

[68] McKinsey & Company, op. cit., p. 14.

Exhibit 4.2
SME Debt Financing Estimates 1996
($ Billions)

Financing Source	Non-residential mortgages	% of total	Commercial loans	% of total	Lease contracts	% of total
Domestic banks	4.3	23.1	51.0	59.6	0.6	9.0
Foreign banks	0.2	1.1	2.9	3.4	0.1	1.5
Life insurers	2.9	15.6				
Trust & mortgage loan companies.	4.1	22.6	0.7	0.8	0.1	1.5
Credit unions or caisses populaires	6.6	35.5	9.5	11.1		
Specialized finance cos.	0.5	2.7	10.9	12.7	5.9	88.1
Crown corporations			5.8	6.8		
Credit cards			4.8	5.6		
Total	18.6	100.0	85.6	100.0	6.7	100.0

Source: Moser and Vanasse, op.cit., Table 9, p. 27

Overall Financing of Small Business

Credit from financial institutions and other forms of debt are only part of the financing used by SMEs and other enterprises. A perspective on the importance of debt finance and lending from financial institutions in the overall financing of SMEs can be gained from Exhibit 4.3, which compares the types of funding used by successful businesses of different sizes.

Exhibit 4.3
Distribution of Liabilities and Shareholders' Equity by Size Class (percentage)

	Size class ($ million sales, 1991)					
Category	**< 1**	**1-5**	**5-10**	**10-25**	**25+**	**All**
Short-term debt	13.2	15.8	18.7	16.6	16.5	14.9
Accounts payable	24.2	24.9	23.6	18.0	15.8	23.8
Long-term debt	17.5	16.7	25.2	23.0	19.7	18.2
Retained earnings	34.0	31.8	17.3	20.7	13.6	30.0
Paid-in capital	5.1	4.8	7.5	15.2	23.4	6.3
Deferred taxes	1.5	1.6	2.1	1.8	3.2	1.7
Other	4.0	4.4	5.4	4.7	7.8	5.1

Note: Percentages are unweighted means.

Source: John Baldwin, William Chandler, Can Le and Tom Papailiadis, *Strategies for Success: A Profile of Growing Small and Medium-sized Enterprises (GSMEs) in Canada*, February 1994 (Catalogue 61-523 E), p. 28. The data were derived from a 1992 survey of 1480 firms with fewer than 500 employees and less than $100 million of assets selected on the basis of their growth over the period 1984 to 1988.

These comparisons show substantially different patterns of funding. SMEs defined as having less than $5 million in sales derive a much greater share of their funding from internal sources than do larger firms. External debt accounts for less than one third of the liabilities of firms having under $5 million in sales, as compared with 40 percent and more for firms with $5 to 25 million in sales. There are also large differences in the use of external equity. Paid-in capital accounts for just 5 percent of liabilities for SME businesses, as compared with 15 percent or more for the firms with sales of more than $10 million. SMEs make up for their lower use of debt and paid-in capital in several ways. They depend much more on accounts payable (almost one quarter of their total liabilities) and internal equity generated from earnings (over one third of liabilities and equity).

The Need for Equity

The dependence of SMEs on equity is not surprising. Many SMEs are start-up businesses that have yet to establish the record of performance necessary to qualify for credit. For them, there are few alternatives to equity and the funding from these sources is limited. But equity can be important to other SMEs, both to support a firm's business activities and to add strength needed to improve access to credit.

A survey of CFIB members stresses the needs of SMEs for equity and its limited availability:

> More than 48 percent of firms with fewer than five employees said they had insufficient equity to carry on business effectively.... 'Angel' investors, venture capital sources and labour-sponsored venture capital funds are seen as accessible by only a small minority of business owners.[69]

The CFIB takes the view that equity building is a process highly dependent on the business owners themselves. It favours tax incentives strengthening the equity of SMEs.[70]

The following section of this paper, which discusses firms in knowledge-based industries, explores aspects of the equity marketplace for smaller firms. The balance of the current section focusses in more detail on debt finance and the relationship between SMEs and banks.

[69] CFIB, *Credit Where Credit is Due*, op. cit., pp. 2, 3.

[70] CFIB, Ibid., pp. 8, 11.

The Relationship between Banks and SMEs

Allan Riding, in his work for the Task Force, suggests that the relationship between banks and SMEs suffers from conflicting expectations on both sides.

SMEs desire a personal relationship with their lenders. However, because lending to SMEs requires the servicing of many customers with small amounts of outstanding credit,[71] it is difficult to establish a meaningful, understanding relationship. Riding notes,

> Small lending balances imply loan account managers must administer large volumes of client borrowers to cover lender overhead and profit. Large caseloads result in little time for monitoring existing borrowers and appraising new applications.[72]

Riding suggests that account managers are unlikely to understand customers' needs and this situation is further aggravated by turnover of managers. Fewer than 40 percent of CFIB members have had the same account manager for the past three years.[73] As a result, Riding says,

> Business borrowers perceive the lender to be non-responsive and uninvolved. Their view, that the lenders do not get to understand their business, leads to dissatisfaction.[74]

The pressure of workload also influences the account managers' attitudes toward risk. Riding argues that the lack of time for due diligence leads managers to perceive the smallest loans as risky to a degree unrelated to the client's actual level of risk. Small business, as a result, will face higher refusal rates than other businesses where greater due diligence can be justified.

Riding compares the relationship between banks and their small business customers in Canada and the United States:

> In the U.S., with its tradition of local banks, bank staffing is likely to be more stable: the lack of a branch system means that loan account managers may spend considerably more years in a single region. Consequently, such personnel are probably more familiar with their customers and are more likely to deal with customers on a personal level.[75]

[71] Over 55 percent of borrowers have outstanding balances under authorizations of less than $50,000, and 40 percent under authorizations of less than $25,000. CBA, *Business Credit Statistics*, as of September 1997, pp. 13, 14.

[72] Riding, op. cit., p. 18.

[73] CFIB, *Submission to the Task Force on the Future of the Canadian Financial Services Sector*, October 1997, Figure 6.

[74] Riding, op. cit., p. 19.

[75] Ibid., p. 24.

He finds evidence that the difference in systems does not affect credit approvals: the turndown rate was 14 percent in both Canada and the United States. He finds, however, that in the United States, "Lenders charge, on average, higher rates of interest yet small business customers report greater satisfaction with their lenders."[76]

This finding suggests that borrowers appear willing to accept pricing according to risk when it results from a stronger relationship with the lender.

Riding summarizes the findings of previous work on the relationship between banks and SMEs with three observations:

> First, business ownership values non-price aspects of the relationship between small businesses and lenders. Second, lenders' performance on those aspects of the relationship that seem to be valued most are not, in aggregate, rated very highly by small business owners. Consequently, business owners express high rates of dissatisfaction with their banking relationship.[77]

The relations between banks and SME borrowers seem to inevitably produce uncertainty and tension for small business. The degree of tension at any time will be determined by the conduct of banks in serving the SME community's needs.

The 1990s Experience

The already strained relationship between banks and SMEs was subjected to further stress by the banks' approach to lending to this sector in the early 1990s. After growing strongly in the late 1980s, bank lending to SMEs reached a peak in 1989 and then slumped sharply (see Exhibit 4.4). Over the next two years, total bank lending under authorizations of less than $1 million decreased by more than $3.5 billion, a 13 percent fall.[78]

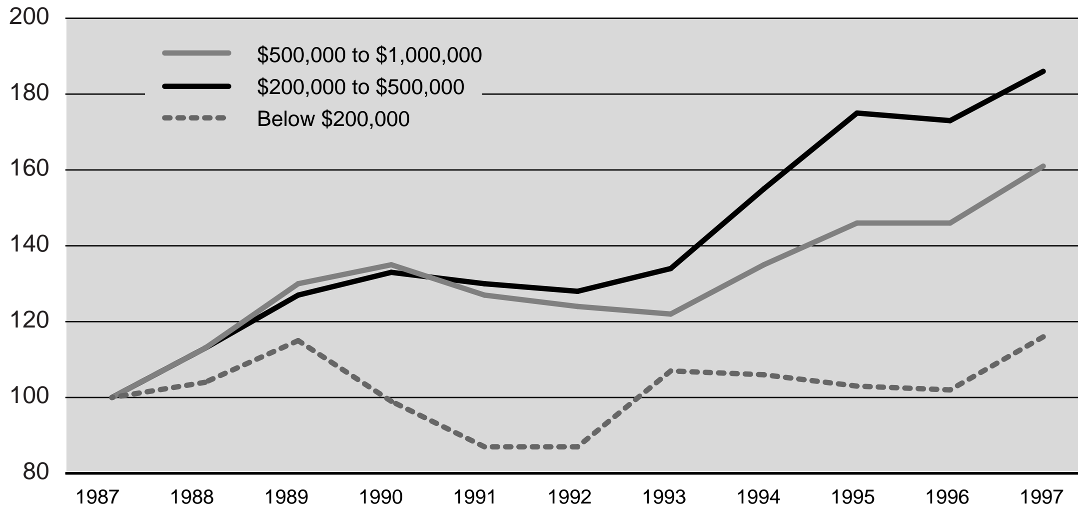
This decline in bank lending hit SMEs especially hard. Further, the brunt of decreased bank lending was borne almost entirely by small firms – that is, those with credit outstanding under authorizations below $200,000. These firms experienced nearly a 25 percent decrease in their outstanding bank credit, while total business lending by the banks rose by 3.2 percent. The only other small business group to suffer a decrease were borrowers under authorizations of $500,000 to $1 million; they suffered a decline of less than 2 percent.

[76] Riding, op. cit., p. 24. McKinsey confirms that interest rates on small business loans in the United States continue to be higher relative to prime rates and cover a broader range than in Canada. See Exhibit 6.11. Lending margins for small business customers in the United Kingdom average 3 to 4 percentage points above the base lending rate and range 2 to 7 percentage points above. See Bank of England, *Finance for Small Business: A Fifth Report*, p. 19.

[77] Riding, op. cit., p. 18.

[78] The only data for bank lending by loan size for this period are available in the *Bank of Canada Review*, Table C5. The smallest loan size consists of loans under authorizations of less than $200,000. These data cover only Canadian dollar loans made in Canada.

Exhibit 4.4
Bank Lending to SMEs, 1987–97



Source: *Bank of Canada Review,* Table C5. Data refer to outstanding loans to business under authorization limits of less than $200,000, $200,000 to $500,000, and $500,000 to $1 million.

This shrinking of small business credit is attributable to a combination of factors from both the demand and supply sides of the credit market. On the demand side, some businesses cut back their credit needs to better weather the economic downturn. The conditions of others deteriorated to an extent that made them too risky by any credit standard. But most of the blame has been placed on the suppliers of credit, who retrenched to an extent that, in retrospect, is recognized as having been unwarranted.[79]

The reduction of credit to small business in the early 1990s was not a uniquely Canadian phenomenon. Real domestic commercial and industrial loans held by U.S. banks fell by 23 percent from the end of 1989 to the end of 1992. Moreover, rough estimates suggest that the decline in small business lending (loans to borrowers with less than $1 million in credit) declined by as much as 38 percent. As Berger and Udell show, a wide variety of causes have been examined including the effects of the implementation of the Basle Accord risk-based capital standards, regulatory capital actions based on leverage ratios, depletion of bank capital from the loan losses of the 1980s, greater regulatory scrutiny with tighter standards, the choice of lower risk profiles by bank managers, reduced loan demand because of macro-economic or regional recessions,

[79] The CFIB quotes a former senior banker as stating “We broke our relationship with the little guy. We got a much better return on other forms of lending.” CFIB, Submission, op. cit., p. 8.

and a secular decline in the demand for bank credit because of the growth of alternative sources of credit.[80] Berger and Udell conclude:

> Although this literature falls short of consensus, the empirical findings do not support risk-based capital as a major contributor to the lending slowdown, but do provide some support for most of the other hypotheses.[81]

While the same research has not been undertaken in Canada, it seems likely that similar forces were at work in this country.

The Response

The immediate aftermath of the credit shrinkage was heightened public awareness and concern about the financing of SMEs, together with higher anxiety in the SME community itself. The proportion of CFIB members expressing concern about credit availability more than doubled from levels of 15 percent in the late 1980s, to reach an unprecedented 37 percent in 1994.[82] All of government, the banking sector as a whole and individual banks have moved to repair the damage.

Government

The federal government responded by reshaping its efforts to support small business financing through its programs and agencies. The Small Business Loans Act (SBLA) was reformed to increase its capacity to support small business financing. The government also revised the mandate of the Business Development Bank of Canada to make it more responsive to the small business community. New collaborations with private-sector institutions have allowed the BDC to tailor its programs more closely to specific business needs.

The Banking Sector

The banking sector has acted collectively through the CBA to improve public understanding of its role in SME financing. It has followed the recommendations of the House of Commons Industry Committee and now publishes extensive information regarding the business lending of the major banks. These efforts have been supplemented by the commissioning of annual surveys of SME attitudes toward, and experience with financial institutions. The surveys have enhanced both the financial institutions' perception of customer issues and public awareness of the performance of the banks.

[80] Allen N. Berger and Gregory F. Udell, "The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle," *Journal of Banking and Finance* (forthcoming), p. 42.

[81] Ibid.

[82] CFIB, *Credit Where Credit is Due*, op. cit., p. 1.

On a broader front, the CBA has launched a public campaign to foster understanding between the banks and the communities they serve. It has also taken specific steps to improve relations with the small business community. The Canadian Bankers Association developed Alternative Dispute Resolution Models and a Model Code of Conduct for Bank Relations with Small and Medium-size Businesses that have now been widely adopted by banks.[83] In addition, to deal with small business disputes, each major bank now has an internal ombudsman supplemented by the sector's Office of the Canadian Banking Ombudsman.

Individual Banks

Individual banks have also sought to rebuild their relationships with SMEs. Some have introduced special credit programs centred on simplified procedures and rapid response to loan requests from small business.

In response to these efforts and the continuing recovery in economic conditions, bank credit to small business appears to have recovered from the lows of the mid-1990s. According to Exhibit 4.4, credit granted under authorizations of from $200,000 to $500,000 and from $500,000 to $1 million has experienced generally quite strong growth since 1993. By the end of 1997, outstanding credit in these authorization categories had grown to levels that were 38 percent and 16 percent, respectively, higher than previous peaks. The recovery of credit for the group of smallest borrowers has been slow, however, despite the improving economic climate. After a substantial improvement in 1993, credit outstanding under authorizations below $200,000 declined in each of the three following years and regained its previous peak level only in 1997.

The market response has not been confined to traditional lenders. Financing alternatives for small business have expanded with the emergence of asset-based lenders, many of which better fit the specific needs and circumstances of SMEs. Other new participants have entered specific markets they judge to have been underserved. Newcourt Credit Group, for example, has become a substantial presence in the asset-based lending market, and Wells Fargo now offers unsecured small business lines of credit of up to $75,000 using credit scoring without branches or a physical presence in Canada.

[83] As discussed earlier, the Thompson Lightstone survey suggests, however, that the code may not be followed in practice.

The Continuing Effects

Not surprisingly, the relationship between banks and the SME community is not as healthy as one would like. SMEs remain anxious about their access to credit. The share of CFIB members concerned about credit availability remains at 28 percent, considerably improved from the 37 percent in 1994 but well above the 15 percent levels of the late 1980s.[84] Many small businesses remain distrustful of their banks. The CFIB finds that the proportion of members applying for loans has dropped steadily from 73 percent in 1987 to just 61 percent in 1997. Some members felt that "they had been so badly burned by their financial institution, that they would in future operate without bank financing, even if it meant lost opportunities."[85]

The Changing Environment for SME Financing

Like other parts of the financial sector, the financing of SMEs is facing many forces of change. The most significant are the changing nature of SMEs themselves, changes in the financial sector, and new financing techniques.

Changing Nature of SMEs

The growth of employment and output in the service sector exceeded that of all other business sectors – primary industry, manufacturing and construction – throughout the period from 1977 to 1997. As a result, the service sector increased its share of employment from 66 percent in 1977 to 73 percent in 1997. As the service sector increases its share of economic activity, the number of SMEs involved in producing services, rather than goods, also grows.

These changes in the structure of Canadian industry have added to the difficulties of SME financing. Unlike the sectors that lost ground, the service sector does not generally hold the same physical assets in capital and inventory as goods-producing industries. Many of these service firms lack the security traditionally needed for commercial bank lending.

Change in the Financial Sector

There has been a general trend, for several years now, on the part of the banks to seek to increase fee income and reduce reliance on interest income. This trend coincides with the increasing importance of equity markets as a source of finance worldwide, and with the very much stronger growth of mutual funds than bank deposits. All of these trends suggest that the nature of intermediation is changing, a phenomenon that is likely to have consequences for traditional sources of credit for SMEs.

[84] CFIB, *Credit Where Credit is Due*, op. cit., p. 1.

[85] Ibid., p. 4.

Further, the role of the traditional bank branch is changing and some SMEs will continue to suffer from an ongoing migration of some functions away from branches as reduced volumes become uneconomic. Credit functions have already been removed from many branches to regional credit centres, and many community-based businesses are finding greater difficulty in gaining access to the banking contacts needed for credit and advice.

New Financing Techniques

SME financing has traditionally depended on an established relationship between the supplier of the funds and the businesses receiving the funds. These relationships informed the lender about the risks and provided the opportunity to monitor and control them. New techniques are starting to displace traditional approaches by reducing the need for relationships and by separating credit decisions from the supply of funds. These techniques include credit scoring, securitization and asset-based financing

Credit Scoring

Credit scoring is a technique that simplifies credit approval by using statistical profiles to judge credit risks electronically. It can reduce both the cost of small business lending and the time needed for approval. By reducing costs, it may extend the availability of credit, especially to some small business borrowers.

Credit scoring could benefit many SMEs by reducing the need for a relationship with a lender. Credit scoring will not, however, benefit all borrowers. Start-ups and young businesses will often not be able to show the past performance typically needed for this technique.

Credit scoring has already made an impact on SME lending in Canada. Several of the major banks have credit programs with simplified application and quick decision making based on credit scoring. In some cases, credit scoring is used to complement the judgment of credit officers. Credit scoring also provides the basis for the targeted SME credit programs recently introduced by Wells Fargo for Canadian customers.

Securitization

Securitization may also change the environment for SME credit. A loan becomes securitized when the holder transfers its claim to a third party as part of a package of similar claims. Securitization effectively separates credit origination from its funding.

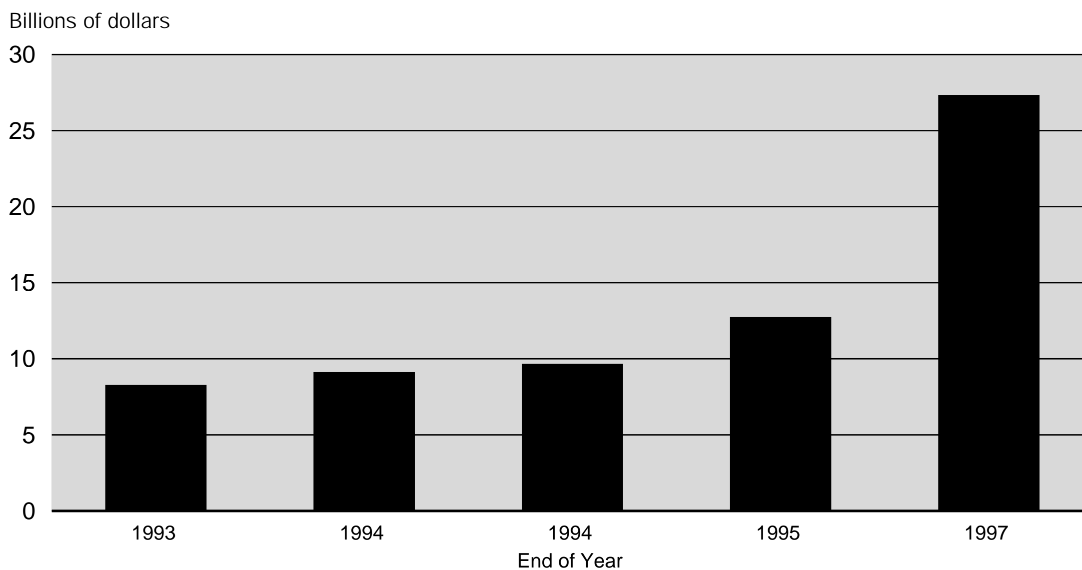
Securitization allows traditional lenders such as banks to continue lending with less regard to their funding. In addition, it reduces the capital that banks need to hold by removing loans from their books. As banks sell their securitized assets to institutions, increased funding becomes available for new loans, including new loans to SMEs.

Securitization allows originators of loans to specialize by removing balance sheet constraints on their ability to fund. Newcourt Credit Group, for example, specializes in loan origination and management but does not hold the loans it originates on its own books. This approach effectively allows specialists in loan origination to emerge and grow without the requirement for large amounts of capital on their balance sheet.

Securization also permits new suppliers of funds to enter the SME market. Institutions or even individuals lacking the expertise to make SME loans may provide funds for that purpose to the loan originators. Of course the originators must tailor packages of diversified securities which will provide a reasonable risk and reward profile to their purchasers.

Securitization has not yet developed in Canada to the same degree as in the United States. Nevertheless, securitization may have potential for increasing small business financing. Securitization of assets has recently begun to expand very rapidly in Canada, with total assets securitized growing from $9.6 billion in 1995 to $27.3 billion in 1997, a 183 percent increase in just two years (Exhibit 4.5). Furthermore, securitization of SME loans in the United States had been limited until recently to loans guaranteed by the Small Business Administration, and was made possible by the government guarantee and standardized terms. There are signs that securitization may be practical for

Exhibit 4.5
Total Asset-Backed Securities Outstanding



Source: Dominion Bond Rating Service, *Securitization: Year-end Review of Canadian Asset-Backed Securities*, 1997.

some normal business loans. In discussing the spread of securitization in the United States, the Chairman of the Federal Reserve Board commented:

> Numerous types of assets are routinely securitized, including residential mortgages, commercial mortgages, auto loans, and credit cards. In addition, medium- and large-size businesses, including some that are below investment-grade, regularly access the commercial paper market by securitizing their trade accounts or other assets. Recently securitization and credit-scoring are beginning to be applied to small business lending.[86]

Asset-based financing

Asset-based financing is a term used to describe both asset-based lending and leasing. The supplier's point of contact with the borrower for either of these is through the vendor of the asset to be financed, thereby reducing much of the concern about the user's credit-worthiness. Many asset-based lenders and lessors have established links with manufacturers and vendors to facilitate this type of financing.

Leases allow businesses to use equipment without tying up cash assets or using credit lines. A lease also reduces risks for the user of equipment since disposal of the asset becomes the responsibility of the lessor. This feature will be especially advantageous to users of equipment in fields where fast-changing technology creates uncertainty about the asset's future value.

The techniques of credit scoring, securitization and asset-based financing may reinforce each other to improve financing for small business. Credit scoring increases the scope for securitization by identifying comparable credit risks. Similarly, the prospect of securitizing encourages lenders to adopt credit scoring. Asset-based financing aids securitization by reducing the need to assess borrowers. Securitization increases the scope for credit scoring and asset-based lending by freeing specialists to originate loans without holding them.

However, these techniques are unlikely to help all businesses. Credit scoring is of greater assistance to small firms with established track records; asset-based lending finances new equipment; and securitization adds to the financing of less risky and easily assessed claims. These techniques are unlikely to help a new service business that lacks management skills, that needs a bank-customer relationship for credit and advice, and has no physical assets.

[86] Alan Greenspan, "Remarks by the Chairman of the Federal Reserve Board at the Conference on Bank Structure and Competition on the Federal Reserve Board of Chicago", May 1, 1997, p.2.

Enhancing the SME Financing Relationship

Distrust of banks and other financial institutions by SMEs serves neither the parties nor the nation well. SMEs lose the opportunity to forge business relations vital for access to the financing they need to prosper and grow. Financial institutions lose opportunities for deploying their funds profitably. Overall, the nation suffers because two sectors crucial to its economic health do not contribute to the fullest extent possible.

Past findings on SME financing lead to the conclusion that the tensions and pressures from conflicting expectations between SMEs and suppliers of credit make this a difficult market to serve. Moreover, the community was poorly treated by the withdrawal of credit in the early 1990s. Progress has been made to restore the relationship through efforts by government and financial institutions. Nevertheless, the Task Force believes more is needed, and can be done, to ensure that the SME community and the country are better served.

Competition

The Task Force believes that the single most important condition for a well-served SME community is a competitive marketplace. Many of the Task Force's recommendations are directed at strengthening competition. Measures are outlined to ease entry barriers for foreign financial suppliers and to support new domestic financial institutions, such as cooperative banks. Changes are also proposed to enhance the capacity of existing institutions, such as credit union centrals and smaller trust companies, to participate more extensively in financing small business.

The Task Force also believes that market developments are likely to provide new sources of competition in the future. Some such developments are already evident. The Business Development Bank of Canada, is playing a role in providing innovative quasi-equity instruments. BDC is filling an important niche and developing constructive partnerships with private sector lenders.

There will probably be more such developments as markets continue to evolve. As mentioned earlier, for example, the securitization of loans could enable small businesses to tap new sources of funds. The Task Force encourages the Government to work with financial sector intermediaries to help develop a market for securitized SME loans in Canada. The Business Development Bank of Canada may have a role to play in this regard, either as an originator of securitized SME loans or as a partial guarantor of securitized loan packages.

Other Background Papers describe the manner in which financial institutions such as insurance companies are moving closer to the chartered banks in many of the financial products they provide. The Task Force expects that this convergence of business will continue and will encourage more non-traditional

suppliers of financing to enter the small business market. As insurance companies undertake business activities in which they hold or accept funds from their customers, perhaps aided by access to the payments system (as proposed by the Task Force in Background Paper #2), the insurance industry will assume some of the responsibility which the banks have borne as deposit-takers to provide credit to Canadian businesses. It should be noted that insurance companies are already increasingly active in the small business market as purchasers of asset-backed securities originated by companies such as Newcourt Credit Group.

The Need for Equity

As this paper has demonstrated, for many small businesses the unmet financing needs relate more to a lack of equity funding than to any lack of credit. The banks have not been traditional suppliers of equity, particularly in high-risk equity situations. The Task Force nonetheless encourages banks and other financial institutions to pursue their recent seed capital and venture capital initiatives (described in more detail later in this chapter). Although deposit-taking institutions, with their fiduciary responsibilities to depositors, must be cautious about large-scale equity investment, they should consider ways to increase the supply of equity capital to smaller firms, through the specialized financing corporations and venture capital partnerships that are consistent with their prudential responsibilities.[87]

Institutional Initiatives

The Task Force believes that financial institutions should strengthen their day-to-day efforts to respond well to the financing needs of SMEs. As has always been the case, this will require a deliberate effort to build and maintain effective on-the-ground relationships with SMEs. The Task Force has heard much from members of the small business community and their associations about the frustration caused by a rapid turnover of account managers and the resulting inability for the small business representative to build and maintain the personal credibility which underlies a sound small business-banker relationship. The Task Force urges banks to find new and creative ways to address that problem, including the establishment of career paths and compensation incentives that create long-term meaningful careers for community-based account managers. Financial institutions will also enjoy enhanced relationships with the communities they serve if they are able to adopt regional and local procurement policies in which there is a meaningful role for local suppliers of goods and services.

[87] The Bank of England reports that Lloyds Bank has launched an Equity Option Loan that provides finance in return for an equity option in the SME's business. Op.cit., p. 18.

The Task Force has heard complaints from several individuals and groups about the impact of centralized bank decision making. The Task Force has made inquiries of the banks and has ascertained that all the large banks have delegated regional credit authority of up to at least $4 million. The Task Force understands the need for the banks, as responsible stewards of the deposits they hold, to apply due diligence in all of their credit and other financing decisions. However, the Task Force also urges a continued decentralization wherever it is feasible, including meaningful delegation to the local level.

Pricing for Risk

The Task Force believes that banks should be able to price appropriately for risk. What this means is that where higher loan rates than are now charged are necessary to extend credit to a borrower who today would be denied credit, the bank should feel that it can charge the appropriate amount for the credit without risking a negative community reaction.

The Task Force understands that today, few if any loans are granted by Canada's major banks at rates in excess of prime plus 3 percentage points. In contrast, in the United States, where credit to small business is perceived by that sector to be quite readily available, financial institutions offer their customers a much wider variety of terms and prices. There appear to be more innovative approaches in the U.S. market to the design of financing packages for SMEs and a greater willingness to price for risk. Similarly, the Business Development Bank of Canada is extending credit to Canadians at rates in excess of prime plus 3 percentage points.

Anecdotal evidence suggests to the Task Force that SMEs in Canada are probably being denied credit which they would receive in the United States if they were prepared to pay higher interest costs.

The Task Force would not, of course, encourage a regime of pricing for risk if, in its implementation, it simply provides a veil behind which the banks increase their spreads on SME loans that they would grant anyway, at lower rates. That having been said, the Task Force believes that the availability of credit, properly priced for risk, would provide more financing to businesses which need it. At present such businesses either go without the credit and presumably fail or abandon their business plans, or are not started in the first place. Alternatively, their owners are obliged to finance the businesses personally by still more expensive techniques such as extended payment terms on their personal credit cards. A more flexible policy would resolve these problems.

Better Information

Better information about SME financing needs and how they are being met will help enhance the relationship between SMEs and suppliers of financing. Such data can provide valuable information on profitable market opportunities to

suppliers; can assist SME firms in knowing the full range of participants in the market and the niches they are serving; can assure the community that expectations are being met; and can assist governments as they refine the public policy framework.

In particular, as mentioned earlier, more disaggregated financing data that can be linked to characteristics of firms would allow a more sophisticated and more meaningful analysis of credit gaps and financing issues than has been possible so far. Small business will continue to be an important source of economic growth and employment, and it will become increasingly critical to develop a better understanding of the issues it faces.

The Task Force is proposing a comprehensive data collection, analysis and publication program. This, it believes, is an important step in improving financing opportunities for SME firms and for enterprises in knowledge-based industries as well. Details are set out in the final section of this chapter.

Financing Aboriginal Businesses

As noted earlier in this paper, one area of SME financing where specific problems exist is the financing of aboriginal businesses. The indigenous people of Canada are increasingly active in the Canadian business community. First Nations government structures and economic activities are changing rapidly and are directed toward achieving self-sufficiency and self-reliance. In recent years, considerable steps have been taken to support the financing of aboriginal businesses.

Several financial institutions have a special focus on the banking needs of aboriginal communities. There are a number of First Nations credit unions. Peace Hills Trust Company is a native-owned trust company with branches in three provinces. The First Nations Bank of Canada was incorporated in 1997 as a joint venture of the Saskatchewan Indian Equity Foundation and the Toronto-Dominion Bank, with the intent that it will ultimately be owned entirely by First Nations people.

Many other Canadian banks have taken initiatives directed at providing financing to aboriginal bands, businesses and individuals. For example, banks have established special lending units or programs to serve the emerging needs of these communities.

Indian bands and individuals have established businesses, some large and many smaller, in important sectors of the economy. As they continue to do so, they are increasingly dealing with financial institutions and, like other Canadians, they will rely on them to provide financing.

The Task Force has met with representatives of some of the aboriginal financial institutions and has discussed aboriginal financing issues with representatives

of the banks. The Task Force has also reviewed the report of the National Aboriginal Financing Task Force (the "NAFTF Report"), which was tabled in 1997.[88] The NAFTF Report made a number of recommendations to aboriginal community leaders, governments and private-sector financial institutions, all designed to provide aboriginal people with better access to capital. Among those recommendations were the following:

- The NAFTF Report identified Section 89 of the Indian Act as an important impediment to access to capital for aboriginal small business. This section prohibits the seizure of on-reserve real and personal property, thereby preventing its use as collateral. Although the NAFTF Report noted differences among aboriginal people as to whether land should be available as collateral, it proposed that community leaders should support changes to the Indian Act, the Small Business Loans Act (SBLA) and the Farm Credit Act to permit movable personal property to be used as security.
- The NAFTF Report urged financial institutions to participate, through the provision of loans and preferred share investments, in the financing of aboriginal capital corporations, which would be providers of capital to aboriginal enterprises.
- Finally, the NAFTF Report noted the lack of sufficient data on how much capital was now being accessed by aboriginal people from financial institutions. It recommended that, as a part of its SME data collection program, the CBA compile information on the banks' financing of aboriginal businesses and governments.

The attention of the Task Force was also directed to security difficulties encountered by financial institutions because of legislative restrictions on the assignment for security of treaty entitlement monies and other funds payable by the federal government to Indian bands.

It is important that aboriginal communities and individuals have the necessary tools, including access to capital, to participate fully in the Canadian economy. In some regions of the country, where there are large aboriginal populations with a considerable land and economic base, First Nations are and will continue to be important factors in economic growth and employment.

The Task Force urges financial institutions to continue to be supportive of the initiatives of aboriginal people and to respond to their special needs with tailored innovative financing programs. It further believes that the Government should respond positively to the suggestions noted earlier, which

[88] National Aboriginal Financing Task Force, *The Promise of the Future: Achieving Economic Self-Sufficiency Through Access to Capital. Report of the Nation Aboriginal Financing Task Force – Final Report.* 1997

are aimed at providing greater flexibility in the provision of collateral in normal lending transactions. The Task Force also endorses the NAFTF Report recommendation that better data be collected on the financing of aboriginal enterprise. Proposals of the Task Force described later in this chapter will respond to that recommendation.

The Financing of Knowledge-Based Industries

Canada and other industrialized countries have been experiencing a shift in economic activity toward the so-called "new economy." The knowledge-based industries (KBIs) which are at its core have consistently outperformed the total economy in terms of output and employment from the 1970s onward.

Many of these industries consist of small, high-growth enterprises operating on the frontiers of technology. These businesses, by their size and the nature of their activities, pose serious problems for conventional suppliers of financing. Like other early-stage enterprises, knowledge-based businesses rarely offer the security of physical assets. Their technologies often cannot be easily understood, and they differ from other businesses in the nature and degree of risk that they present. As a result, judging their commercial potential often requires specialized expertise.

This section deals with the conduct of financial institutions in the financing of the new economy. It examines the definition and role of the KBI sector, financing issues facing KBI firms, and approaches for improving KBI financing.

The Definition and Role of the KBI Sector

There is no single agreed definition of KBI. Knowledge-based firms are those in which the development and application of knowledge is critical to the production of goods or services. To state this is to illustrate the difficulty in coming to a precise definition, since all production requires knowledge of one form or another. Drawing the line is difficult and can be somewhat arbitrary.[89]

Increasingly, as innovation spreads throughout the economy, more and more industries that have traditionally not been considered knowledge-intensive are adopting new, sophisticated methods of production. Knowledge and its applications will soon be critical to the production of most goods and services in a modern economy, from computer software design to dairy farming. In a very real sense, all modern enterprises can claim to be knowledge-based firms.

[89] For example, in Thompson Lightstone's 1998 survey, small business owners were asked to self-identify and 68 percent said they were "knowledge-based"; cross-referencing with an Industry Canada working definition based on Standard Industrial Classification (SIC) codes revealed that only 4 percent of the same group were considered KBI. Thompson Lightstone, op. cit., p. 171.

Because of the difficulties in understanding the nature of the sector, the Task Force commissioned a research study aimed at providing an overview of the structure of the sector and its importance, the financing issues it faces and the progress that has been made by financial institutions in responding to these issues.[90] The study reports that there are two principal definitions that tend to be employed for analytic work.

Industry Canada has developed a definition which is based upon grouping industries by SIC codes, depending on how intensively they use information, advanced technology or scientific research. This is a very narrow definition, according to which KBI firms accounted for about 5 percent of Canadian gross domestic product in 1990. It is unsatisfactory in the sense that it undoubtedly underestimates the contribution of knowledge-intensive activity to production and employment in Canada, and it does not correspond to entrepreneurs' own perceptions of the nature of their activity.

A more relevant definition was developed for the federal government by Frank Lee and Handan Has.[91] Lee and Has adopted a human capital approach to measuring KBI, focussing for example on matching human capital skills with activities such as research and development (R&D) that create and apply knowledge. In order to construct the definition they looked at the ratio of industry R&D to industry output, and at other ratios, such as the ratios of R&D employees, professionals (scientists, engineers) and post-secondary educated workers to total employees. On the basis of this approach, they examined 161 industries and categorized them into 55 business sectors. They then classified these sectors into three groups: high-knowledge intensive (16 sectors), medium-knowledge intensive (25 sectors) and low-knowledge intensive (14 sectors). Lee and Has concluded that, in 1990, the high-knowledge intensive sector contributed 17 percent of gross domestic product, more than three times the percentage under the narrower definition cited earlier.[92]

Analysts at Industry Canada have used the Lee and Has definitions to track output and employment trends in the KBI sector from 1971 to 1991. They found that the high-knowledge intensive sector grew consistently faster than the rest of the economy over that period. The share of the high-knowledge intensive sector in industrial output increased from 12.8 percent in 1971 to 18.3 percent in

[90] Groupe Secor Inc., *Financing Knowledge-Based Small Business,* Research Paper prepared for the Task Force on the Future of the Canadian Financial Services Sector, Ottawa: September 1998. The bulk of this section is based on the findings in this research report.

[91] Frank Lee and Handan Has, "A Quantitative Assessment of High-Knowledge Industries Versus Low-Knowledge Industries," in Peter Howit, ed., *The Implications of Knowledge-Based Growth for Micro-Economic Policies.* Ministry of Supply and Services Canada, 1996.

[92] This sector includes, for example, scientific and professional equipment; communication and other electronic equipment; aircraft and parts; computer and related services; business machines; engineering and scientific services; and pharmaceutical and medical products.

1991.[93] The share of employment in high-knowledge intensive activities increased from 10.7 percent of total employment in 1971 to 15.4 percent of total employment in 1991.[94]

A number of banks have also developed operational definitions of KBI firms for the purposes of financing programs.[95] For example, the Royal Bank defines KBIs as companies which possess some of these characteristics: (1) intangible assets; (2) a high knowledge component; (3) high R&D; (4) use of advanced technology; (5) export activities; and (6) patents or licences. The CIBC defines KBIs as knowledge-based businesses that create or apply technology. The Bank of Montreal defines them as entities relying on research and development and technology in the delivery/production of goods and services. Scotia Bank defines them as firms that use some form of innovation to create a competitive advantage leading to rapid growth.

Whatever definition one uses, there can be no dispute that KBI firms are becoming increasingly important to growth and employment in modern economies. The creation, development and application of knowledge are at the root of innovations that raise productivity and living standards, and that enhance our quality of life. The maintenance of a business climate conducive to the formation and growth of KBI firms is important to Canada.

Financing Issues Facing KBI Firms

In considering the financing issues facing KBI firms, the Task Force followed an outline developed by Secor,[96] and displayed in Exhibit 4.6.

The four types of firms identified in the table are all knowledge-intensive firms. But they are distinguished by different development cycles and risks, with the science-based and high-tech craft firms being the ones that are generally most innovative and difficult to assess from a financing point of view. These are the companies that are the focus of the Task Force's concern.

Financing Challenges

The major challenges for these KBI firms when they seek financing are the lack of fixed assets traditionally used to secure conventional forms of credit, the difficult information and assessment problems they pose to suppliers of financing, and the unique operational risks that they face.

[93] Surendra Gera, and Kurt Mang, *The Knowledge-Based Economy: Shifts in Industrial Output*, Working Paper 15, Industry Canada, January 1997, p. 17.

[94] Surendra, Gera and Philippe Masse, *Employment Performance in the Knowledge-Based Economy*, Working Paper 14, Industry Canada and Human Resources Development Canada, December, 1996, p. 12.

[95] Secor, op.cit., p. 20

[96] Ibid, p. 16.

Exhibit 4.6
Sector's Typology of KBI Firms

Type of Firm	Typical Sectors	Product Development Cycle	Critical Success Factors	Major Risks
Science-based	• Phamaceutical • Health biotech • New materials	Long (5 to 10 years) • need for clinical trials, regulatory approvals, testing	Breakthrough scientific product or application protected by patents	• Rival patents • Undiversified patent portfolio
High-tech craft	• Software products • Medical equipment • Avionics	Long (5 years) • accumulation of knowledge and testing	State-of-the-art product dominating a niche market	• Loss of innovation team • Loss of market niche
Integrators	• Information Technology services • Telecommunications	Short (1 to 2 years) • rapid development of competing services	Superior delivery of of complex products or services into a broad market	• Failure of project management/ overruns • Changes in standards
Technology users	• Food processing • Financial services	Short (1 to 2 years) • need for continual fine-tuning to market	Innovative distribution of new technology embedded in mature product or service	• Loss of tech suppliers • Changes in standards

Lack of Fixed Assets

The assets of many KBI firms differ from those of other businesses and even other SMEs. These firms lack the assets necessary for conventional bank loans or for asset-based financing. Their assets consist primarily of people with knowledge and expertise, products under development, and the potential to reap the fruits of past research through successful marketing.

Information Problems

Many KBI firms have not prepared adequate business plans, lack basic business skills and have no record of past performance. As a result, they pose unique challenges to potential suppliers of financing. Often, the financing decision will require the supplier to assess the commercial viability of the proposed project. The specific knowledge to make an adequate assessment will be rare among traditional commercial lenders, and often those who are best placed to make the most realistic assessment are likely to be competitors, or potential competitors, of the KBI firm. Addressing this problem requires matching the right expertise with the right enterprise.

Special Risks

The risks of financing KBI firms differ substantially from those for other SMEs because the risks to the firms themselves are different. As indicated in Exhibit 4.6, science-based and high-tech craft firms often operate in environments where the loss of key people, unexpected and sudden market

developments, or patent surprises can make a fundamental difference to the success of the enterprise. Risks are high. Traditional bank loans, with their fixed commitments, may not be suitable for KBIs and particularly for early-stage KBIs.

To the extent that traditional lenders expect the failure rates of KBIs to be higher than for other businesses, they must do well enough on successful projects to recover and offset losses on others. This cannot be easily achieved through traditional debt financing with the usual margins for risk. Rather, financing must take the form of equity, or at least be structured around equity with flexible and innovative debt instruments, to meet the needs of both the enterprise and the supplier of funds.

Financing Patterns

As a result of these challenges, KBI firms tend to rely more heavily on permanent capital, as opposed to long-term debt. A recent Statistics Canada study surveyed 4,000 firms that had survived for at least 10 years in an effort to determine what characteristics had contributed to their survival. The survey distinguished highly knowledge-intensive firms from less knowledge-intensive firms and focussed on financing structure. Among its conclusions are the following[97]:

- Over half the financing of highly knowledge-intensive firms (53 percent) comes from permanent equity, compared with about 41 percent for less knowledge-intensive firms.
- Of the permanent equity, about 43 percent comes from retained earnings and 10 percent from owners and employees.
- Of the financing that comes from external sources, there is a higher dependence on suppliers than is the case for less knowledge-intensive firms (9 percent versus 5 percent) and a much lower dependence on banks and trust companies (27 percent versus 39 percent).

The authors conclude:

> Successful entrants match the structure of their financing to the nature of their industry.[98]
>
> Firms that are operating in dynamic, high-knowledge industries use relatively more equity capital. Conversely, firms in low-knowledge industries rely more heavily on debt financing. Within each, firms involved in goods production typically have a longer term associated with their debt than service providers, who draw more on short-term debt.[99]

[97] Joanne Johnson, John Baldwin and Christine Hinchley, *Successful Entrants: Creating the Capacity for Survival and Growth*, Statistics Canada, May 1997 (Catalogue 61-524-XPE).

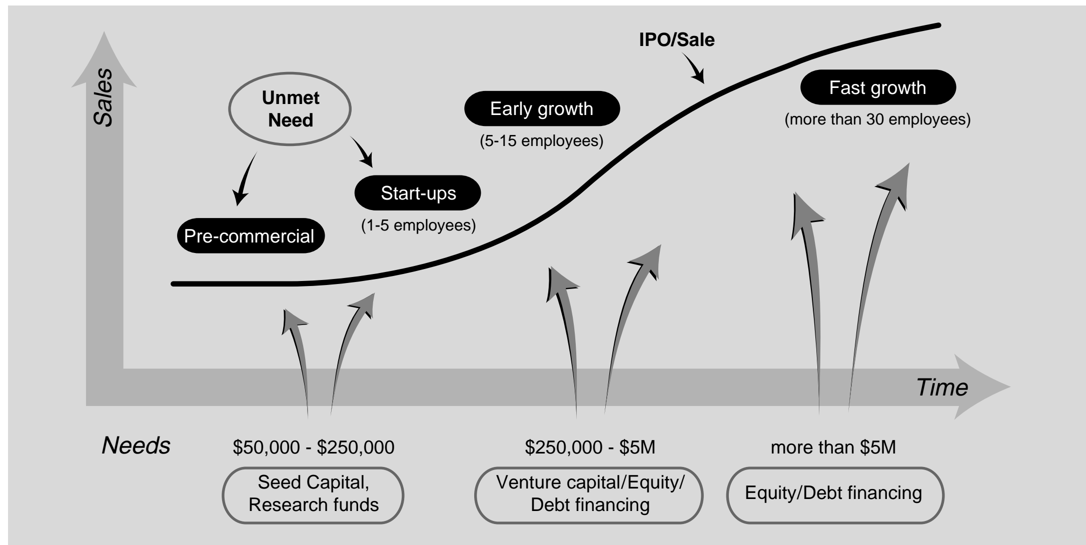
[98] Ibid., p. 44.

[99] Ibid., p. 11

Financing Stages

Secor outlines three stages with respect to the financing needs of KBI enterprises: seed capital, venture capital and equity financing. These are depicted in Exhibit 4.7 and discussed in the following pages.

Exhibit 4.7
Financing Stages



Sources: *SECOR analysis and Sharwood & Co.*

Seed capital is vital to any fast-growing firm attempting to capitalize on its innovative technology. At this stage in its life cycle, the entrepreneur has already completed initial research, typically funded by grants or support under a corporate umbrella. The firm has also advanced through the "commercial idea development" stage where it has been funded by the founders' own resources or "love money" from friends or relatives. The firm is typically beginning to build a management team, carrying out market tests and applying for patents.

A firm seeking seed capital will typically need up to $250,000. Many of these firms will lack both the cash flows and assets necessary to support the commitments of debt financing. They will require patient financing in some form of equity. Traditional sources of funds at this stage are informal investors or "angels," who have been estimated to account for 90 percent of all start-ups below $1 million.[100]

[100] Gordon Sharwood, *Key Sources of Growth Capital*, April 16, 1997.

The federal government has several instruments that it now uses to support KBI firms at the seed capital stage. These include the following:

- Tax incentives, and particularly the refundable Scientific Research and Experimental Development (SRED) Tax Credit. This tax credit is enhanced by similar credits in most provinces and, because it is refundable, provides a cash flow in early years even when there are no sales. Banks have been willing to provide bridge financing for SRED refunds. For smaller firms the administrative burden of compliance is reported to be a problem.
- Industry Canada grants and infrastructure to assist skill development and information exchange. The Canadian Community Investment Plan (CCIP) program provides funding to communities that wish to match innovative local business with local sources of capital. Many of the networks set up under CCIP also provide management and planning support to entrepreneurs.
- The Business Development Bank (BDC), which provides targeted financing. The BDC has increased its emphasis on the small KBI market since its mandate was revised in mid-1995. The BDC sees its role as bridging between angels or informal investors and the venture capital investors and banks, which have different risk/reward objectives and different areas of competence. In fiscal 1997, some 36 percent of all BDC loans went to KBI firms. Typically, BDC charges a higher premium as well as royalties on sales, with the possibility of postponing repayment.[101]
- Regional economic development agencies, which have entered risk-sharing agreements with the banks to support KBIs.
- Loan guarantees and insurance, provided through the SBLA and Export Development Corporation.

Seed capital was the only area where Secor identified a gap in the availability of funds. Secor also concluded, "In our view, there are no major regulatory or legislative initiatives that should be taken to promote the supply of seed stage capital.[102]" Secor also added that the best ways to improve the flow of seed capital were through tax incentives and initiatives to promote the development of infrastructure to link investors and entrepreneurs and support the development of management skills.

As their businesses begin to grow, KBI firms turn to *venture capital*. At this stage, the firm will have launched its product and expanded to the point where it has 5 to 15 employees. It will have expanded to the point where it has the need and capacity to seek outside finance.

[101] Secor, op.cit., p. 26.

[102] Ibid., p. 6.

Venture capital is typically supplied in the form of equity finance, usually in the range of $500,000 and up. Venture capitalists differ from banks and other financial institutions in their approach to investing in entrepreneurial firms. They will typically be active investors involved in making strategic decisions for the firms and playing a role in determining the management.

The Canadian venture capital industry has exploded in the past five years and now plays an important role in funding early-stage and expansion financing.[103] Driven in large part by generous tax credits for labour-sponsored venture capital funds from governments, funds under management increased from $2.5 billion in 1986 to $8.4 billion in 1997. New commitments grew from $300 million to more than $1.8 billion over the same period.[104] Information prepared by Macdonald and Associates for the Canadian Venture Capital Association[105] shows that, for the past two years:

- venture capital investments in technology have accounted for 66 to 69 percent of total funds allocated[106]; and
- a sizeable amount of venture capital went to the smallest firms, with 33 percent of all funding going to firms having less than $1 million in revenue, and with such firms accounting for 41 to 44 percent of the investments made.

Some concerns have been expressed about the future of the venture capital industry with respect to its ability to mobilize funds and attract new funds to replace commitments. Over the past few years, labour-sponsored venture capital funds appear to have faced a shortage of acceptable projects for funding. In particular, the largest labour-sponsored fund in Ontario failed to meet the performance standards for shareholders' capital invested in capital projects, and faced substantial penalties from both the federal and provincial governments.[107] In addition, there are concerns about the flow of capital into the industry. In 1996, the group of labour-sponsored funds did not fully replace the capital that they committed to new investments, and during 1997 new capital fell short of commitments for the industry as a whole. Nevertheless, the venture capital industry still has sufficient liquidity to support a significant level of new commitments.

[103] Ibid, p. 31.

[104] The $1.8 billion in new commitments in 1997 compares favourably with the U.S.$12.8 billion in commitments made by the U.S. industry in the same year. The U.S. industry is acknowledged to be the world leader. See Price Waterhouse, National Venture Capital Survey, 1997 at www2.pw.com/vc.

[105] Canadian Venture Capital Association, observations from 1997 Venture Capital Data.

[106] Macdonald & Associates, *The Canadian Venture Capital Industry,* Research Paper Prepared for the Task Force on the Future of the Canadian Financial Services Sector, Ottawa, September 1998. The report uses a definition of technology that is broader than the KBI definition used here, so these numbers do not relate directly to science-based and high-tech craft firms.

[107] John Heinzl, "Fund sits on a chunk of cash," *Globe & Mail*, Report on Business, February 2, 1998. p. B1.

KBI firms that successfully mature through the seed capital and venture capital funding stages will typically look to ***public markets*** or to groups of sophisticated ***private equity*** investors as they require additional funding.

The number of initial public offerings (IPOs) by KBI firms on Canadian exchanges has fluctuated considerably through the 1990s, ranging from 5 in 1992 to 25 in 1996. The peak year was 1993, when 29 IPOs totalling $620 million were brought to market by KBI firms. From 1990 through the first half of 1997 there have been 83 IPOs in total, averaging almost $21 million. Issue sizes have been in the $10 million to $35 million range.[108]

Impediments to Raising Equity Capital

In research conducted for the Task Force, Allan Riding reviewed the work of earlier public policy studies, which indicated that Canadian securities laws and practices were not as conducive as they might be to the raising of early-stage equity financing. He concluded that a number of initiatives should be taken to better understand the equity needs of small firms and to make equity financing more readily available.

Most of these initiatives fall within provincial jurisdiction, as they relate to the terms and conditions upon which shares may be sold to third parties. Nevertheless, the Task Force wishes to emphasize the findings of the Riding study so that they may be given consideration as provincial authorities consider regulatory change.

In particular, the Riding study indicates that, unlike debt financing on which there has been substantial commentary, very little research has been done on the demand for equity capital among owners of growing businesses. Riding argues that such research is needed. The study reaches the following conclusions:

- The report finds that regulations and policies that govern the raising of capital, particularly certain provisions of the provincial securities acts, hinder small firms attempting to obtain start-up and early-stage equity capital. The study identifies the need to broaden the exemptions from securities regulation for "love money" investments, to relax offering memorandum requirements, and to eliminate or shorten hold period requirements and other resale restrictions, all as suggested by a 1994 MacIntosh study. Riding also urges the development of a special offering system related to small public offerings, including a simplified prospectus requirement, an "accredited investor exemption," and relaxed disclosure and filing requirements, all as proposed in the report of the McCallum Task Force to the Ontario Securities Commission in 1996.

[108] Secor, op.cit., p. 33.

- The Riding study also refers to the history of the Alberta Junior Capital Pool Program and suggests that consideration be given to extending the program to other parts of Canada as a mechanism for entrepreneurs to raise monies for small business ventures.
- Finally, the study examines the Small Corporate Offering Registration system, under which small U.S. enterprises may raise up to $1 million of new capital per year from public equity markets with minimal registration and disclosure requirements. He suggests that it may provide a useful model for Canada.

A detailed review of Canadian securities legislation is beyond the scope of the work of the Task Force. However it is evident from the Riding study that access to equity is the key issue for many growing small businesses, particularly for KBIs. It is equally clear from the Riding research that earlier studies, not yet acted upon, have identified legislative barriers to resolving those equity needs.

The barriers which have been identified do not relate to the role of financial institutions in providing equity capital. However, they appear to be significant. The Task Force urges provincial regulators to review and act expeditiously on the recommendations noted in the Riding study, except where they would give rise to serious questions of investor protection.

The Role of the Banks

The primary need of KBI firms, at various stages in their early life, is equity. But they require debt as well for working capital in the early stages of their existence, and as mezzanine finance when they grow past the venture stage. Banks are active participants in financing KBI firms, and over the past three to four years have substantially changed their strategic approach to KBI financing.

Banks have been active in providing credit to KBI firms. At the end of the third quarter of 1997, the seven major banks (including the Hongkong Bank, which has a strong presence in this market) had made $7.1 billion in loans under outstanding authorizations of $25.3 billion.[109] There were 16,071 KBI loan customers and 15,555 of them had loans of less than $5 million. The Royal Bank and the Bank of Montreal together with Hongkong Bank are the major providers of loans under $1 million to small KBI firms, and were among the first to open specialized banking centres for KBI clients.[110]

[109] CBA, *Business Credit Statistics*, as at September 30, 1997.

[110] Secor, op.cit, p. 22.

Secor reports:

> Most banks are developing KBI-specific lending models and risk assessment approaches to assess enterprise value rather than just individual assets, and to recognize the lending value of intangible assets. Indeed not all banks require full collateralization of loans in the traditional sense. But the definition of what can be accepted as collateral for KBI clients with intangible assets needs further development and circulation into the field.[111]

In 1994, as part of a broad review of SME financing, the Toriel Committee recommended that deposit-taking institutions should "accelerate the process started by some banks of establishing special units to serve knowledge-based SMEs."[112] All major banks have now established special KBI units within their retail banking groups. These units have dedicated personnel for KBI financing at between 4 and 20 regional centres per bank. Secor describes the purposes and activities of these groups as follows:

> These groups are trying to develop their bank's share of this segment of the small and medium-size commercial market.... These banks have embedded their KBI groups for the most part within their commercial (retail) banking units. The banks intend to grow their KBI units as the market develops, particularly through development of KBI teams within their regional banking centres, using specialized staff to scout for new opportunities.[113]

In addition to direct lending, the banks have also been actively participating in partnership agreements with federal economic development agencies and with the Business Development Bank. In partnership with Western Economic Diversification, the Federal Office of Regional Development-Quebec and Federal Economic Development Initiative in Northern Ontario, the banks make loans on commercial terms for R&D and for product and market development, and the agency contributes a loan loss reserve of up to 12.5 percent. The banks have also concluded agreements with BDC under which BDC will offer quasi-equity loans to bank KBI clients. This helps BDC extend its customer network and allows banks in effect to expand their product offering.[114]

In 1992, federal legislation was changed to allow banks and other federally regulated financial institutions to create "specialized financing corporations" that could be used to make equity investments in SMEs and KBI firms. Financial institutions are able to commit up to 5 percent of their regulatory capital to

[111] Ibid., p. 24.

[112] Toriel Committee, op.cit., p. 2.

[113] Secor, op.cit., p. 20.

[114] Ibid., p. 27.

these corporations. In turn, the corporations can take ownership interests in other businesses for up to 10 years, for amounts of up to $90 million each.

Banks are increasingly providing equity as well as debt through these specialized financing corporations. All the major banks now have venture capital funds, which they operate directly or (more commonly) in partnership with others having more experience in venture capital.

Further, several of the funds are dedicated to specific areas, including seed capital. For example, the Bank of Montreal is involved with partners in a Western Seed Investment Tech Fund ($25 million); the Royal Bank and partners have launched the Canada Growth Company ($30 million), which specializes in life sciences, information technology and advanced materials; and the Royal Bank, with another set of partners, has launched the NeuroScience Partners Fund ($52.5 million to $100 million). The Bank of Montreal Capital Corporation has $200 million with several technology programs, and the Royal Bank has RB Capital Corporation with $350 million to provide equity finance to KBI firms.

Macdonald & Associates reports that, in total, the banks committed an additional $740 million to their venture capital funds and an additional $150 million to private venture funds between 1994 and the end of 1997. During 1997, bank venture capital funds invested $129 million, mainly in first-time financings.[115]

Some concern was expressed to the Task Force that many of these equity initiatives have yet to make extensive investments. The Task Force recognizes that the context of venture capital with the attendant risk profile requires review of a large number of proposals to find projects with sufficient potential for investment. The Task Force does wish to encourage the banks to aggressively pursue the new opportunities available to them to invest in Canada's KBIs. Their success is a national priority.

Approaches to Improve KBI Financing

Clearly, a great deal of progress has been made in KBI financing and much is happening. The principal challenge is to ensure that timely and accurate information is available on the range of opportunities that exist, and that the substantial funding commitments that have been made do, in fact, get allocated in a timely way.

The Task Force is proposing that a comprehensive data collection and analysis regime be implemented to address financing issues related to SMEs and KBIs. The details of this regime are set out in the next section of this chapter. This

[115] Macdonald & Associates, *The Canadian Venture Capital Industry*, op. cit., p. 11.

will be an important resource to ensure that all participants and potential participants in the market are well informed.

However, the existence of a resource does not automatically mean that it will be utilized. There are cultural issues that need to be addressed and resolved within the banks. Consistent, determined leadership will be required to develop a culture that can appropriately manage investing in and financing of KBIs. There is an urgent need to come to grips with this challenge, since many of these firms have the potential to provide the innovation that can keep Canada competitive in a knowledge-based global economy.

The Task Force has considered how best to provide a continuing focus of attention on the issues related to KBI financing. The Task Force is proposing that Industry Canada table an annual report on the state of SME and KBI financing with the House of Commons Industry Committee. The Task Force suggests that the Industry Committee might consider holding annual hearings on the state of KBI financing, at which the CEOs of the major banks could be invited to appear and update the committee on the progress that is being made in their efforts to support the industries of the new economy.

The Need for Better Information and Policy Analysis

In Canada, as in other countries, the most serious problem facing policy makers and financial institutions alike when they address the SME and KBI markets is the inadequacy of information relating to the financing needs (both debt and equity) of SMEs and the supply of financing to them. Much better market information is critical for public policy development.

Surprisingly, a lack of data hampers understanding of small business in many developed countries. An OECD report concludes, "Demand for reliable, relevant and internationally comparable data on SMEs has been rising. Statistical offices have started to collect and publish relevant data but serious shortcomings persist."[116]

This shortage of data on small business financing also exists in the United States even though the Community Reinvestment Act has required disclosure. A Federal Reserve study observes:

[116] OECD, *Small Businesses, Job Creation and Growth: Facts, Obstacles and Best Practices* (Paris: OECD, Directorate for Science, Technology and Industry, 1997) p. 9.

> Surprisingly little is known about small firms as borrowers or about their credit market. Survey data do confirm that small businesses rely on financial intermediaries – especially commercial banks – as lenders, but the information available to us about the role of intermediaries as small business lenders, about the underlying costs and risks associated with small business loans, and about the factors that influence decisions to supply credit or demand credit is meagre at best. There is no single source of data that includes all the information to consider in assessing the availability of credit.[117]

Substantial progress has been made in Canada recently in the collection of data on bank financing of SMEs:

- The Canadian Bankers Association now publishes detailed quarterly statistics on the lending activities of major chartered banks. These data give particular attention to lending to SMEs.
- The CBA also publishes annually the loan loss provisions taken by major banks against their business lending.
- Thompson Lightstone, under the sponsorship of the CBA, conducts an annual survey of SMEs concerning their "needs, expectations and satisfaction with financial institutions." This source also includes results from a survey of bank loan officers concerning credit applications and approvals.

In addition, several industry groups, including the Canadian Venture Capital Association and the Canadian Finance and Leasing Association, provide regular reports of their members' activities in financing SMEs. The Canadian Federation of Independent Business also regularly surveys its members about their perceptions and experience with respect to the availability of credit.

Despite this progress, further information is needed in the following areas:

- *Coverage of other suppliers of credit to SMEs*. The CBA data cover only the lending activity of major chartered banks. Comparable coverage is needed of the activities of other significant suppliers of credit (such as trust companies, credit unions, insurance companies and pension funds). The coverage should include both direct lending and indirect lending through securitized instruments.
- *Coverage of other types of financing*. CBA data include only bank credit to SMEs. The coverage of types of finance should be extended to include loans, leases and equity finance.

[117] Katherine Samolyk, "Small Business Credit Markets: Why do we know so little about them?" *FDIC Banking Review* (vol. 10, no. 2, 1998), p. 15.

- *Further detail on the characteristics of borrowers.* The current breakdowns in the data are comprehensive on matters such as size of credit authorization and the industry of the borrower. Further information is needed on the rural-urban division of credit and other measures of the size of the borrower.
- *Data collected from the perspective of the SME.* We have insufficient data from the perspective of the SME itself. Such data would indicate the significance of different sources of funds in the overall financing of SMEs.
- *Data collected from independent sources.* The CBA collects data on small business lending of major banks. In addition, it sponsors the surveys conducted by Thompson Lightstone to collect information on customer experience. Both types of information are crucial to understanding the availability of financing and the performance of institutions in meeting their customers' expectations. The CBA and Thompson Lightstone surveys appear to be carried out objectively. Nevertheless, some groups seem unwilling to accept the findings out of concern about bias in collection or interpretation. Collection and interpretation of the data by a government agency would facilitate acceptance.
- *Particular attention to KBI data.* The data should include coverage of the suppliers and types of financing going to KBIs. As discussed below, establishing a consistent definition of KBIs should be a priority.

Approaches to Better Data

Data collection should be directed toward the needs of accountability and policy with respect to SME and KBI financing, and should not become an end in itself. More extensive collection of data can be justified to address the following issues:

- Who provides financing to SMEs? What types of financing are they providing? How is the importance of various players and sources changing over time?

  Answering these questions will determine whether all institutions suited for different types of financing are active. It should also help identify obstacles to participation of specific institutions or to the availability of specific types of financing.

- From the point of view of the small businesses themselves rather than the suppliers of financing, what are the types of financing they depend on and how successful are they in finding it?

  This information looks outward from the enterprise toward its funding sources. The data could describe differences in funding patterns between successful and unsuccessful enterprises. The findings could also suggest whether

there are particular segments of the SME market that are underserved. If, for example, SMEs in an industry or region receive less financing from particular sources than do others, this may point to regulatory or other obstacles.

- Are there underserved parts of the business community that can be profitably served?

  Information about business financing conditions in well-defined markets may signal opportunities for private suppliers. The Federal Reserve, in its *Report to Congress on the Availability of Credit to Small Businesses*, observes:

> One of the primary benefits of data collection may be its use for financial institutions themselves. Financial institutions will have, for the first time, accurate data of the geographic distribution of small business loans. This will enable institutions to evaluate their products and services, and overall market penetration for small business finance. Bankers have indicated that the data will be helpful to them in designing better products and services responsive to various market segments of the small business market.[118]

The CFIB also believes that greater information can enhance competition in the market for SME financing:

> Our objective is to heighten awareness of the issues that will, in turn, result in an improved financing environment for SMEs throughout Canada. Some financial institutions have chosen to use the data to better understand their markets, to change course and to improve performance and market share in the sector.[119]

No one approach can provide all the data needed on SME and KBI financing. For some issues the perspective of institutions will be needed; for others, that of the SME users. Advances in the understanding of SME financing can be achieved through regular surveys from both perspectives. In addition, more in-depth analysis may be required on a regular basis and for specific questions reflecting current issues or problems.

Three separate data sources will be needed to give a suitable overview of SME and KBI financing:

- Institutional surveys. These would be extensions of the present CBA survey of bank credit to small business and loan loss provisions.
- Experience surveys. These would carry on the recent Thompson Lightstone surveys of SME and lending officer experience.

[118] Federal Reserve Board, p. 25.

[119] CFIB, Submission to the Task Force, op. cit., p. 7.

- User surveys. These new surveys would be directed toward the sources of financing used by SMEs, and their significance. They would be designed to cover other characteristics of the SMEs (e.g., sales, financial structure, assets and age) that may be necessary for an understanding of their position.

Institutional Surveys

Responsibility for the current CBA surveys of major banks should be assigned to Statistics Canada so as to ensure unbiased collection of comprehensive data. The scope should be extended under appropriate authority to cover all regulated and unregulated financial institutions, as well as government programs, engaged in significant loans, lease, equity investments and securitization activity in the small business market. The precise coverage of these surveys and the definitions used should be developed by Statistics Canada in consultation with data providers, potential data users and representatives of Industry Canada.

The coverage and definitions should be based on the existing survey of bank lending undertaken by the CBA. The survey should provide:

- comprehensive coverage of suppliers, including financial institutions, pension funds, venture capital funds and government programs;
- grouping of loans by size and equity investments in a manner that allows small loans and investments to be tracked and analysed;
- coverage of the financing of knowledge-based industries;
- regional coverage that distinguishes not only between geographic regions but between urban and rural areas within geographic regions;
- information where possible with respect to other relevant characteristics of firms (e.g., assets and revenues);
- definition of small business and knowledge-based firms that are consistent with other analysis;
- the amount of lending and equity financing that takes place under the Small Business Loans Act or other government programs; and
- coverage of the financing to aboriginal business.

Statistics Canada should publish compilations of the data on a regular basis.

In addition, financial institutions that play a substantial role in the financing of SMEs and KBIs should be required to publicly release their submissions to Statistics Canada, with appropriate modifications if necessary to protect the confidentiality of their commercial relationships.

Experience Surveys

Another survey, by Thompson Lightstone provides a different and important perspective on small business financing that goes beyond statistical data. It examines the experience of small businesses with respect to needs, expectations and satisfaction with financial institutions. It shows the degree to which small businesses feel satisfied with their treatment by financial service providers, and indicates the degree of satisfaction with different aspects of their relationship. It also correlates these measures with other characteristics of businesses to determine how well different types of business are being served.

This annual survey, now sponsored by the CBA, should also be conducted under the auspices of Industry Canada, in order to enhance its credibility and provide closer ties between the collection of information and research on small business finance.

User Surveys

The institutional surveys described above will deal with the different types of funding coming from different suppliers. They will not give a comprehensive picture of financing from the point of view of the user. For example, they would fail to show the relative importance of internal and external sources, or different patterns of funding across different types of SMEs.

In order to gain a users' perspective on SME financing, Industry Canada should conduct periodic benchmark surveys of small business users, including knowledge-based firms, to better understand the types of funds they require and the sources of financing they rely on. These surveys should be conducted once every three to five years.

More Focussed Policy Analysis

The state of small business at any time depends on the general state of credit markets. Policy makers in Canada, the United Kingdom, the United States and other industrialized countries turned their attention to the financial needs of small business in response to the credit cutbacks in the early 1990s. The urgency of SME financing and the attention directed to it will always rise as businesses face cuts in their funding. But to the extent that there are structural issues, the financing of SMEs remains important after the attention dies down.

There is a need for a sustained effort to improve understanding of small business financing from a longer-term perspective. More systematic and rigorous policy analysis is required.

The U.K. and U.S. governments have recognized the need to monitor SME financing regularly. The Bank of England now reports annually on small business financing. Its report consists of discussion of current developments in SME

finance together with highlighted topics.[120] Similarly, the Federal Reserve must now report to Congress every five years on the availability of small business financing.

Canada needs similar reporting on the state of small business financing. A dedicated SME Finance Group should be established within Industry Canada to undertake continuing research on SME financing, including that of KBI enterprises. It should oversee the periodic benchmark surveys together with the annual survey now conducted by Thompson Lightstone. It should analyse the data collected by Statistics Canada and also report annually to the Industry Committee on the state of small business and knowledge-based firm financing, and on any special research projects it undertakes.

There are many possible topics for special research. Two topics the group may want to address are the regional availability of financing and gender discrimination.

Analysis of regional financing flows has been limited up to now by the lack of data covering all suppliers of financing. More comprehensive data that include government programs will enable the proposed group to examine regional issues in greater depth.

Much research has been undertaken on gender discrimination in credit. Allan Riding concludes that the evidence does not support the claim of gender discrimination.[121] He also concedes that these results do not convince all parties. Research and analysis from an impartial agency (e.g., the proposed group at Industry Canada) is needed to deal with this and similar issues, such as the financing of aboriginal business and micro-credit.

Toward Better Understanding of Knowledge-Based Industries

Many of the developments in the financing of knowledge-based industries have been recent and their impact has not yet been felt. Assessing the performance of these measures will be limited by a lack of information.

The CBA's *Business Credit Statistics* provides comprehensive information about bank lending. Such credit data deal neither with the critical sources for KBIs nor with the most significant contributions of the banks through specialized financing corporations. Despite the recent steps by the major banks, information limitations make it impossible to judge how well the banks are serving the needs of KBIs. As a result, the collection, disclosure and analysis intended to assist greater understanding of the financing of small business should pay

[120] Bank of England, op.cit. In 1997 the highlighted topics included the costs to small firms in changing banks and the financing needs of ethnic minority businesses.

[121] Riding, op.cit., pp. 27-30.

special attention to the financing of knowledge-based industries. This regime would include reporting of seed capital and venture capital investments of financial institutions and others.

Knowledge-based industries pose an additional difficulty for data collection and analysis because of the different definitions of the sector used for different purposes. The proposed SME Finance Group at Industry Canada should give priority to the adoption of a common definition of knowledge-based industries for data collection purposes and analysis of the sector.

Conclusion

The Task Force believes that creation of a timely, comprehensive, focussed data base, together with regular analysis of specific issues, will allow a regular, fact-based, public discussion of SME and KBI financing issues. Such a discussion will provide critical input for developing effective public policy in these important areas.