

# Regulatory Proposals

**1999-2000**

**Small Business Loans Administration**

July 1999



# Table of Contents

- Canada Small Business Financing Act Regulations ..... 1
  - Description ..... 1
  - Alternatives ..... 3
  - Benefits and Costs ..... 4
  - Consultation ..... 5
  - Compliance and Enforcement ..... 7

# Canada Small Business Financing Act Regulations

## Description

The Canada Small Business Financing Act (CSBF Act) which received Royal Assent on December 10, 1998, increases the availability of financing for the establishment, expansion, modernization and improvement of small businesses. Under the CSBF Act, commercial lenders in the private sector are encouraged to make commercial term loans in respect of real property, equipment and leasehold improvements. Subsection 14(1) of the CSBF Act provides for Regulations to carry out the purposes and provisions of the CSBF Act. The CSBF Act will replace the Small Business Loans Act (SBL Act), which will be repealed on March 31, 1999.

The attached Regulations do not substantially change the parameters of the existing Small Business Loans (SBL) program which was created in 1961, and is scheduled to sunset on March 31, 1999. Many of the administrative details of the program, which were divided between the SBL Act and its associated Regulations, have now all been consolidated into the annexed Regulations, under the overall legislative framework of the new CSBF Act.

These new Regulations respond to a number of issues raised during the comprehensive review of the SBL Program, and to recommendations of the Public Accounts Committee resulting from a 1997 audit of the existing SBL program. These Regulations will provide a clear definition of "related borrowers", who collectively, will be limited to a loan of \$250,000 under the CSBF Act. Lenders will also be required to apply the same degree of due diligence in their approval and administration of CSBF Act loans as they do in their conventional lending. No change is being made to the 2 per cent up front loan registration fee, while the existing 1.25% administration fee is to be remitted more frequently than the annual remittance under the existing Regulations. Lenders will now be required to provide greater information on the loan registration form, and security requirements have been clarified. Lenders will continue to have 36 months to file claims; however, they will only receive interest at the full loan rate for the first year, followed by interest at one-half the loan rate for the second year and no interest during the third year. This is intended to encourage lenders to deal more promptly with realization and finalization of their claims. The Regulations introduce interim claim payments for lenders if a guarantee has been provided by the borrower and if the lender has realized on all security except for any guarantee. Ministerial authority for correcting inadvertent errors by lenders will also be increased. Lenders will be permitted greater flexibility in taking, releasing and substituting various types of security.

As before, a loan shall be limited to 90 per cent of the eligible cost, including the cost of any non-reimbursable tax and duties, and the Crown share of loan losses claimed will remain at 85 per cent of eligible net loss. A borrower will continue to be eligible under the CSBF program if revenues are not expected to exceed \$5.0 million during the year the loan application is approved, if its business will be carried on for profit in Canada, and if it does not include the business of farming or a business having as its principal object

the furtherance of a charitable or religious purpose. The formula establishing the Minister's contingent liability for a specific lender also remains unchanged.

Technical Changes to the Regulations Since Prepublication Industry Canada held extensive discussions with the Canadian Bankers Association (CBA), Canadian Restaurant and Foodservice Association (CRFA) and contacted the Canadian Franchise Association (CFA), La Confédération des caisses populaires et d'économie Desjardins du Québec and the Credit Union Central of Canada (CUCC). As a result of these discussions, Industry Canada agreed to a number of technical improvements to the Regulations in response to comments received from the Canadian Bankers Association (CBA). No other substantive comments were received in the prepublication period. In addition to responding to comments, drafters improved the clarity of the text.

Concern was expressed by the CBA about lenders' ability to provide quarterly administration fee payments for April 1, 2000, given the overriding priority to update information systems for Year 2000 compliance. Subsections 4(1) to (7) of the Regulations have been amended to phase in these reporting requirements and fee payment schedules from 1999 to 2001. Subsequent years will require that lenders pay the administration fee quarterly and provide the basis for their calculations. Subsections (8) and (9) have been added giving the Minister authority to allow lenders, who experience difficulties in complying, to submit fee payments for all quarters except the final quarter based on estimates. This provides more assurance to lenders, particularly when administrative impediments (such as systems failures) impede their ability to submit these reports, that all their loans will not, as a result, lose the CSBFA guarantee.

The Regulations have been amended to meet lenders' concerns about their ability to take security where the CSBFA loan is part of a series of secure loans. The lenders are now comfortable with these provisions, which also improve the security of CSBFA loans.

With regard to the release of primary security, paragraph 16(2)(b) has been added to allow the lender to require an appraisal of security assets being released under the same criteria outlined in subsections 9(1) and (2). This was requested by the CBA to allow lenders to seek assurance that the amount being applied to the loan is equal to the value of the assets being released in the event of a sale of the assets, ensuring that the release of secured assets for repayment towards the loan does not result in payment of an amount less than the real value of the assets being released.

There was also a need for clarification of the 25 per cent cap on personal guarantees and what can be realized on by the lender in the case of default. Subsection 19(1) has been redrafted to clarify a lender's right to realization on personal guarantees and other sections have been changed, in consequence. These changes clarify lenders' responsibilities in taking security and realizing on guarantees.

At the CBA's request, sections 23 to 27, which deal with non compliance in the case of claims on defaulted loans, have been amended to allow claims to be paid on that portion of the loan to which non compliance does not relate in cases where the inadvertent non compliance did not contribute to the claim for loss. This will reduce the number of rejected claims. The cost to the borrower of such errors must be reimbursed. Likewise, this should provide an incentive for lenders to improve their vigilance, since repeated errors which appear intentional will result in claims being rejected.

Section 28 has been amended to remove a 90 day limit on the late submission of detailed reports on loans outstanding (as per sections 34 and 35). This section has been amended so that claims payments by the Minister will be withheld until such time as required reports have been received by the Minister. This will be a significant incentive to encourage accurate and timely reporting under the Act.

Paragraph 30(1)(b) has been revised to make it clear that the loan can be renegotiated when being transferred at the request of the borrower, but that the new loan must respect the maximum loan term of ten years from the date of the original loan and other requirements, such as due diligence and the maximum interest rate. This measure should clarify the Regulations in such a way as to reduce the incidence of inadvertent non compliance with them.

These changes respond to all comments received by stakeholders through the prepublication process. It should be noted that, due to extensive consultation prior to prepublication, there was general support for the approach taken in these Regulations. The CBA and the CRFA have written to Industry Canada to indicate their support.

## **Alternatives**

### Alternative 1: Maintain the status quo

This option was not adopted in view of substantial comment from stakeholders during the extensive consultations during the comprehensive review of the SBL program, together with the recommendations made by the Public Accounts Committee resulting from the Auditor General's 1997 audit of the existing SBL program. In addition, the previous untidy distribution of administrative details between the SBL Act and its associated Regulations had given rise to numerous ongoing difficulties in administering the SBL program.

### Alternative 2: Discretionary contribution program rather than legislation and Regulations

This option was not proposed as such a program would require separate agreements with each of the 1,500 lenders through which the current program is delivered. Such an alternative would create a significant administrative burden and may lead to inconsistent administration of the program across the country.

### Alternative 3: The new Regulations

This option relieves the CSBF Act of considerable minor administrative detail and renders the program more amenable to efficient and effective administration. The option addresses the recommendations of the Public Accounts Committee and the Auditor General together with comments and recommendations of lenders, borrowers, and other important stakeholders affected by changes to the SBL program. The Regulations incorporate the results of the broad consultations undertaken as part of the comprehensive review of the existing SBL program. The Auditor General indicated to the Public Accounts Committee that the dual objectives of increasing the availability of financing, while seeking to recover the claim costs of the program through registration and administrative fees, require careful analysis. Industry Canada has proposed that

corrective adjustments to the program identified through ongoing program monitoring relating to attainment of these dual objectives, would be more quickly introduced through regulatory amendments than through legislative amendments to the CSBF Act itself.

## **Benefits and Costs**

### **Impact on borrowers**

Although the impact on borrowers at the time of making and registering of loans is designed to remain minimal, the regulatory changes proposed include additional information requirements designed to improve management of the program and reduce loan losses and claims costs in certain high risk sectors or loan types. Also included is a comprehensive definition of “related borrower”. Ultimately, this information will be used to introduce program improvements and to maintain the integrity and affordability of the program through a reasonable fee structure. The regulatory changes also seek to benefit borrowers and lenders by providing more flexibility in the taking, substituting and releasing of security and guarantees.

### **Impact on lenders**

Lenders will be required to collect and provide more information on loans and borrowers, and to remit annual administration fees more frequently than presently. Lenders will be required to make and administer their loans under the CSBF Act with the same due diligence as they exercise for their conventional loans. The terms of payment of interest to lenders on claims have been shortened, to encourage lenders to deal more promptly with realization and finalization of their claims. Broadening of previous provisions in connection with correction for inadvertent errors by lenders and the taking and releasing of security should reduce risks for lenders using the CSBF Act. Lenders will also benefit from the proposed payment of interim claims under the CSBF Act under certain identifiable circumstances.

### **Impact on government**

The regulatory changes are anticipated to result in a modest reduction in overall claim costs over time and a realignment of administrative efforts and costs, especially in data collection, reporting and evaluation activities. The comprehensive definition of “related borrowers” has been included to limit loans to related companies pursuant to the recommendations of the Auditor General. In addition, the Regulations provide a better set of tools to monitor program performance and costs, such as greater information on loans and borrowers. Cash management will also be improved through more frequent remission of fees by lenders, and through better management of interest expense with the payment of interim claims where applicable.

### **Impact on the environment**

There are no negative environmental considerations.

## **Consultation**

The annexed Regulations have been subject to: two rounds of detailed written comments; and face to face consultations with stakeholders throughout the financial services and small and medium sized business communities; and a 15-day prepublication in the Canada Gazette, Part I (February 6-21, 1999). A Notice of Intent was published in the Canada Gazette, Part I on October 31, 1998 for seven days. Consultations included six of Canada's major chartered banks and numerous other lenders (caisses populaires, credit union centrals). As well, selected special interest groups (Canadian Federation of Independent Business, Canadian Bankers' Association, Canadian Restaurant and Food services Association, Canadian Financing and Leasing Association) were consulted directly. In the course of these consultations, stakeholders raised a number of significant issues that the proposed regulations take into account. Draft Regulations were tabled by the department in the House of Commons Standing Committee on Industry and in the Standing Senate Committee on Banking, Trade and Commerce. The House of Commons Standing Committee on Industry held a hearing on the Regulations and reported them back to Parliament on February 22, 1999 without comment. Communication by stakeholders through the prepublication process has resulted in minor, technical changes now incorporated in the Regulations.

In addition to the consultations outlined above, studies have been conducted as part of the comprehensive review of the SBL Act in areas including economic impact reviews, default analysis, cost benefit analysis, development of a future program evaluation framework, and extensive consultation with stakeholders to examine attitudes and opinions of both present and potential stake holders on a broad variety of small business financing issues. These studies concluded that, overall, the program continues to be a vital, useful and efficient tool in facilitating debt financing to small emerging businesses. Program fundamentals are reported to be sound as is, and the program is seen to being delivered with a minimum of red tape by the designated network of some 1,500 financial institutions through their 13,000 points of service (branches and offices) to a small business community. This community continues to need and benefit from the program, and continues to make a significant contribution to employment and economic activity throughout Canada

Fifteen independent focus groups were held with borrowers and potential borrowers, together with targeted focus groups on possible extension of the program to the leasing community and the voluntary sector. These possible extensions, it was concluded, should await results of planned future pilot projects to better assess their impact and value, and are not covered by the proposed Regulations. Consultations and discussions have also been held with other government departments (ACOA, CED - Quebec, WED, Finance , TBS).

While fees and eligibility criteria remain largely unchanged, the new Regulations will:

- provide a clear definition of "related borrowers" who, collectively, will be limited to a loan of \$250,000 under the CSBF Act;
- require lenders to apply the same degree of due diligence in their approval and administration of CSBF Act loans as they do for conventional lending;
- require lenders to provide greater information on the loan registration form;
- provide lenders 36 months to file claims; but also provide that they only receive interest at the full loan rate

for the first year, interest at one half the loan rate for the second year and no interest thereafter;

- introduce interim claim payments for lenders if a guarantee has been provided by the borrower and if the lender has realized on all other security;
- provide ministerial authority to correct inadvertent errors by lenders; and
- permit lenders greater flexibility in taking, releasing and substituting various types of security.

## Compliance and Enforcement

Compliance and enforcement provisions, contained in the enabling legislation, provide for audit and examination of lenders' books and records of account on reasonable (21 days) notice and require lenders to cooperate and assist the Minister as required. If a lender fails to cooperate, the Minister may deny liability for any payment otherwise due to the lender. The Regulations provide for fines and or imprisonment (up to \$500,000 and or five years for indictable offences; \$50,000 and or six months for summary conviction) for a variety of offences under the CSBF Act, including the making of false statements in applications and the disposition of assets or use of proceeds of loans with fraudulent intent.

## Contacts

Serge Croteau  
Director General  
Programs and Services Branch  
Operations Sector  
Industry Canada  
Tel.: (613) 954-5533 - Internet address: croteau.serge@ic.gc.ca

Peter Webber  
Team Leader  
Entrepreneurship and Small Business Office  
Industry and Science Policy Sector  
Industry Canada  
Tel.: (613) 941-2684 - Internet address: webber.peter@ic.gc.ca

**The Canada Small Business Financing Regulations were published in the Canada Gazette Part II, Vol. 133, No. 7 on March 31, 1999. The Regulations came into force on April 1, 1999.**