



CFIB

Research



Banking on Entrepreneurship

Results of CFIB Banking Survey

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[Please click here to view CFIB's Statement to the House of Commons Standing Committee on Finance on Bill C-8 respecting Financial Institutions Legislation.](#)

Summary of Findings

To ensure that financial institutions are playing their part to help foster the growth of the small business sector in the 21st century economy, CFIB surveyed its membership on banking issues between April and June 2000. The survey data provides extensive information on various banking-related issues, such as: overall satisfaction levels with banking institutions; types of financing; amount of financing; loan applications; loan rejections; interest rates and collateral; service charges; the role of foreign banks; on-line banking and bank market shares for the small business sector.

Highlights of the survey findings are cited below:

- **Overall, the majority of business owners are satisfied with the service they receive from their financial institution.** However, ranking institutions according to eight factors places credit unions out in front, followed by HSBC and trust companies. None of the major banks ranked near the top in seven out of the eight factors; the only category in which the major banks obtained a high ranking was on-line services. Caisse populaire Desjardins and National Bank tied for the lowest ranking.
- **Loan applications are rejected for about 1 in 10 small business owners.** The higher the turnover rate of account managers at the same financial institution, the higher the loan rejection rate. Likewise, the smaller or younger the firm, the higher the incidence of a loan application being rejected.
- **It is the young, high performing businesses that are experiencing the greatest difficulty in obtaining financing from financial institutions.** The extent of the underfinanced component of the SME sector differs substantially according to how long the respondent has been in business. More than a quarter (28.6 per cent) of firms that have been in business for 10 years or less (i.e. less established) are considered to be underfinanced. This figure is significantly lower for firms that have been in business for 11 years or more (i.e. more established), at 16.4 per cent. However, the underfinanced portion of those “less established” firms with very strong revenue growth in the past three years is the highest, at 30.8 per cent.
- **Satisfaction with service charges remains low.** Overall, only 40 per cent of business respondents are satisfied with the level of service charges. The level of satisfaction is related to the size of the firm: the smaller the firm, the lower the level of satisfaction. Similarly, the higher the account manager turnover rate, the lower the level of satisfaction. With respect to negotiating lower fees, small and younger firms have less bargaining power than larger and older firms do. Significant variations in satisfaction level exist among provinces and financial institutions.
- **Competition in the financial services sector for servicing the SME market is not expected to intensify due to relaxed rules for foreign bank entry.** Only 1 in 4 respondents view foreign banks as a viable banking alternative within the next three years. This finding reflects the limited presence of foreign financial institutions currently servicing the Canadian small business market.
- **Small business owners do not view on-line banking as a substitute for branch banking.** The limited applications and impersonal nature of on-line banking will likely hinder its proponents’ ability to use the Internet as a way to replace ‘bricks and mortar’ branches.
- **Bank market shares of the small business market have changed significantly during the past decade.** CIBC and the Royal Bank posted the largest losses, while the Bank of Montreal, Scotiabank and the credit unions gained ground. The TD Bank and the National Bank’s shares remained relatively stable. Poor service quality, lack of credit availability, and unfair service charge practices were the most frequently cited reasons by small business owners for switching banks.

Introduction

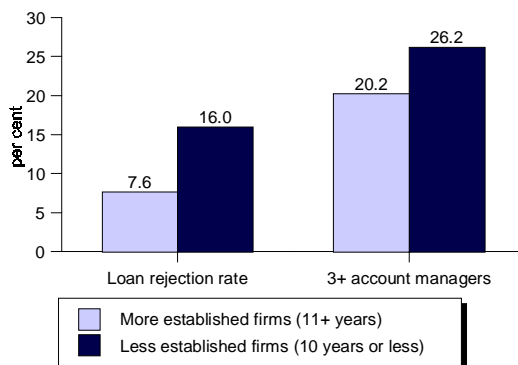
From industrial revolution to knowledge revolution, the Canadian economy has changed dramatically over the past century. The 21st century economy will in large part be built on new ideas and knowledge. It will be more innovative, faster paced, more competitive...more entrepreneurial. To succeed in this “new economy”, Canada will need to become more entrepreneurial in all aspects of business, government and society in general. Small and medium-sized enterprises (SMEs) are by nature typically more flexible and innovative in reacting to change. Their solid contributions to economic growth and job creation to date demonstrate their ability to transform challenge into opportunity.

To continue to capitalize on the challenges in the new economy, SMEs will require the services of a banking sector that understands and responds to their changing needs. Account and deposit services, cash and coin, financing, payroll processing, credit/debit cards, and pensions and savings are just several of many banking services that SMEs rely on to meet both their short- and long-term goals. To ensure that financial institutions are playing their part to meet the needs of the SME sector, CFIB regularly surveys its membership on banking issues.

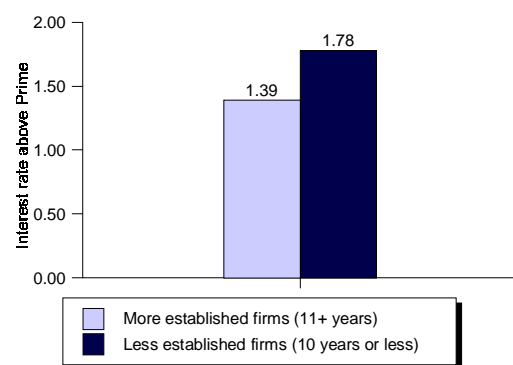
The most recent CFIB survey provides evidence that the banking sector does a satisfactory job at servicing the more established small firms that have been in business for 11 years or more. Unfortunately, the data reveals a different story for those less experienced respondents that have only been in business for 10 years or less and, as a result, have not been subjected to the full business cycle in the economy (i.e., recession to growth). For starters, the proportion of less established business owners who cited they had their loan application rejected by their main lending institution within the past three years was 16 per cent—more than twice the rate for more established firms, at 7.6 per cent (see Figure 1). Secondly, the incidence of account manager turnover is significantly higher among younger firms, at 26.2 per cent, compared to older firms, at 20.2 per cent. Thirdly, younger firms tend to pay 0.39 of a percentage point more in interest for financing than older firms.

Figure 1
Selected indicators: More established firms versus Less established firms

Loan rejection rates and Firms with 3 or more account managers



Interest rate points above Prime rate



These differences beg the question of whether the banking sector is shortchanging the future movers and shakers of the 21st century economy. Failing to meet the needs of young entrepreneurs can only hinder the development of those businesses that Canada needs the most—

The banking sector understands and finances young, small enterprises the least.

those that are fresh with new ideas, full of determination and flexible enough to adapt to changing market conditions. Clearly, a major

challenge awaits the banking sector to meet the needs of this vital component of the Canadian economy. As outlined throughout this report, the survey data shows that the banking sector understands and finances young, small enterprises the least.

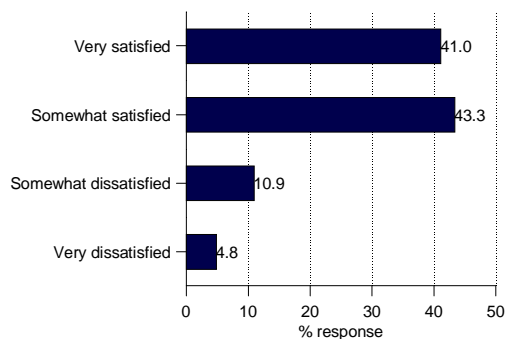
This report is based on a survey questionnaire conducted by mail between April 25 and June 12, 2000. A total of 10,024 responses were received from small and medium-sized independently-owned and operated businesses located in all regions and sectors throughout Canada. The results are accurate to within ± 1.0 percentage points, 19 times out of 20. The margin of error is larger within provinces, industry sectors and other sub-groupings of the survey data.

Satisfaction Levels

(i) Overall Satisfaction:

Overall, business owners expressed a high level of satisfaction with the service quality they receive from their financial institution. More than 84 per cent of respondents indicated that they were either “very satisfied” or “somewhat satisfied” (see Figure 2). These results are notably more upbeat than those found in previous CFIB surveys on banking which consistently showed overall satisfaction levels around 77 per cent.

Figure 2
Overall Satisfaction Levels with Financial Institutions



Given that both the economy and the SME sector have performed strongly in the past several years, it is not surprising that overall satisfaction levels are up. Owners are less likely to express dissatisfaction with their bank when their business is performing smoothly than when times are tough. At the same time, banks are more

Overall satisfaction levels are up, but the major banks still received a low ranking.

likely to accommodate the needs of those small business clients with rising revenues. What is important, however, is that Canada's largest banks have consistently received the lowest levels of overall satisfaction relative to other financial institutions since CFIB started conducting in-depth banking surveys in the 1980s.

(ii) Satisfaction by type of service:

Ranking financial institutions according to satisfaction levels for specific factors leads to the same conclusion. None of the major banks ranked near the top in any of the following areas: level of financing, lending terms, information requirements for financing, service charges, level of understanding of the small business client, treatment by account manager and branch accessibility (see Table 1). The only category in which the major banks obtained a high ranking was on-line banking services. Overall, this data indicates that little has been done within the major banks to better serve the needs of the SME sector with the exception of on-line banking. As outlined later on in this report, however, small business owners do not view on-line banking as a full alternative to branch banking.

Credit unions rank 1st in terms of overall satisfaction with quality.

Table 1: Ranking of Financial Institutions, based on Satisfaction of Service Quality

OVERALL RANKING		Level of financing	Lending terms	Information requirements for financing	Service charges	Understanding of my business	Treatment by account manager	Access to branch	On-line banking services
1	Credit unions	1	1*	1*	1	2	1	2	5*
2	HSBC	2	1*	1*	2	1	2	4	4
3	Trust co.	3*	3	5*	3	4	3*	1	1
4	TD Bank	7	6	5*	5	5	5*	6*	2
4	Alta.Treasury	3	4	3	3*	3	3*	3	11
6	CIBC	6	6*	8	6	6*	5*	6*	5*
7	Scotiabank	9	9*	9	9*	6*	7	5	7
8	BMO	5	5	4	7	10	8*	10	8
8	Royal Bank	8	9	5*	11	11	8*	8	3
10	National Bank	10	6	10	9*	6*	10*	11	9
10	Caisse populaire	11	11	11	7	6*	10*	9	10

* Indicates a tie

Note: Overall ranking is based on an index using equal weights for all eight factors.

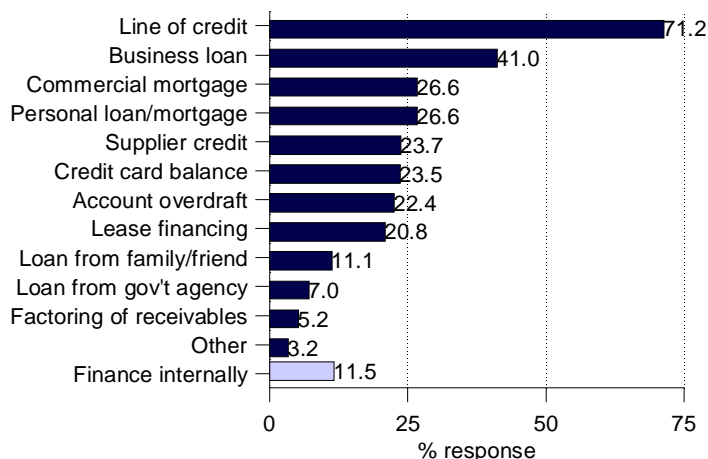
Types of Debt Financing

By a significant margin, lines of credit and business loans are the two chief sources of debt financing for small business. Almost three-quarters (71.2 per cent) of respondents currently have a line of credit with their financial institution, while 41 per cent have a business loan (see Figure 3).

While credit lines and business loans are clearly the mainstay of small business debt financing, there are a number of other popular products. Commercial and personal mortgages, personal loans, supplier credit, and credit cards are all used by one-in-four small businesses. Lease financing and account overdraft protection are also well used, as indicated by one-in-five respondents.

Overall, a loan from a family member or friend is a financing source for only 11.1 per cent of respondents. The incidence of “love money” is much more prevalent for younger firms, with one-in-five firms aged four years or less indicating use of this type of financing. The least common types of financing are loans from a government agency or program, such as the Business Development Bank of Canada, and the factoring of receivables, at 7.0 per cent and 5.2 per cent respectively.

Figure 3
Types of SME Financing



Breaking out the results by the age and size of the firm reveals significant variations. In particular, a higher proportion of younger and smaller firms resort to carrying a credit card balance (a very expensive form of financing) compared to older and larger firms. Conversely, a line of credit or commercial mortgage is much more common with larger and older businesses.

Amount of Financing

The median amount of financing approved by banks and other institutions during the past three years is \$40,000 for the smallest firms, rising to \$1.5 million for the larger businesses (see Table 2). Overall, the amount of financing is up slightly from 1997, but the extent of the increase varies according to firm size. For larger firms with 50 or more employees, the amount of financing increased significantly. For the smallest firms, financing increased by one third. Of particular importance, however, is that loan amounts have remained stagnant or decreased for firms with 5 to 49 employees.

Table 2
Amount of Financing* Approved, by size of firm, 1997 and 2000

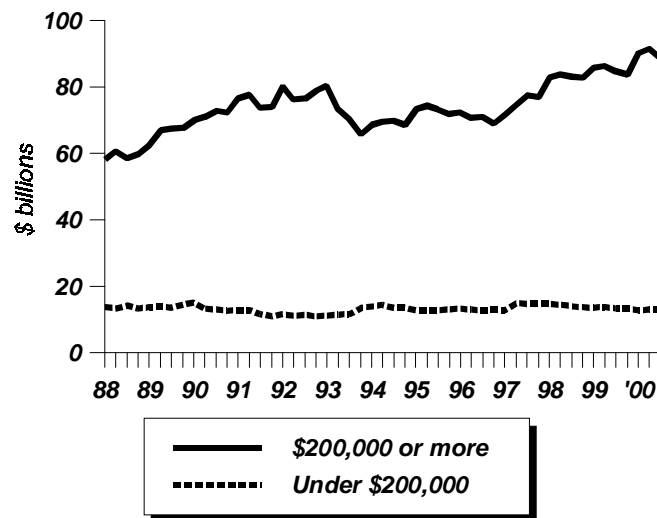
Number of employees	Median amount of financing approved,	Median amount of financing approved,
	1997	2000
	(\$)	(\$)
0-4	30,000	40,000
5-19	100,000	100,000
20-49	350,000	307,500
50-99	650,000	1,000,000
100+	1,250,000	1,500,000
Total	97,000	100,000

* Includes the term loan amount and/or credit line limit approved by a financial institution.

Bank of Canada data show that loan activity for amounts under \$200,000 has remained relatively stable throughout the 1988-2000 period (see Figure 4). In contrast, larger loan activity of \$200,000 or more has increased significantly. This finding is problematic considering that the majority of small businesses with loans (64.5 per cent) are for amounts under \$200,000. Examination of this data in real (inflation-adjusted) terms would accentuate this dilemma—the trend line for smaller-size loan activity would be downward sloping and the line for higher-size loan activity would be slightly flatter.

Small-size loan activity remains stable while large-size loan activity has increased significantly.

Figure 4
Chartered Bank Lending to Business
(Authorized Loan Limits)

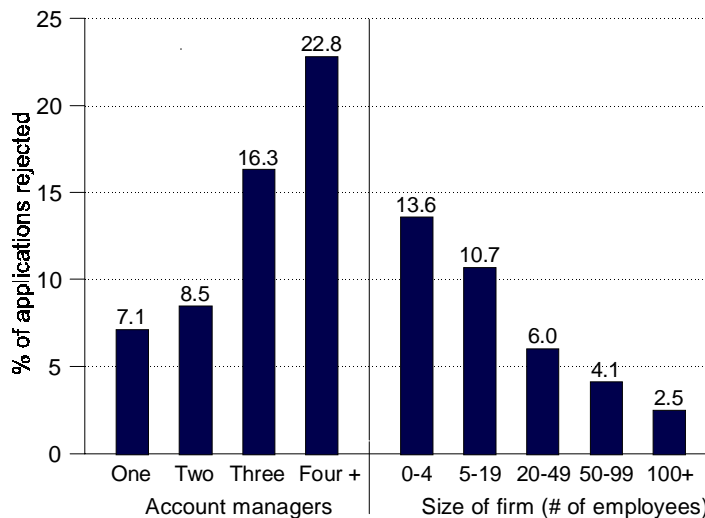


Sources: *Bank of Canada Review*, quarterly data for Q1 1988 to Q3 2000

Loan Rejections

Although loan amounts are slightly higher in 2000 than three years ago, loan applications for about one-in-ten (10.5 per cent) business owners are still rejected by financial institutions. Consistent with past CFIB research, the loan rejection rate varies according to the number of account managers and the size of business (see Figure 5).

Figure 5
Loan Rejection Rates, by number of account managers and size of firm



The higher the number of account managers at the same financial institution, the higher the loan rejection rate. For example, the loan rejection rate was 7.1 per cent for those applicants with the same account manager in the past three years, while the rate for those who had four or more account managers was significantly higher, at 22.8 per cent. This is understandable

The higher the account manager turnover rate, the higher the loan rejection rate.

given the importance of the client-account manager relationship. New account managers do not always understand the specific needs of their small business client. Nor are they fully aware of the track record of the owner, the history of the

business, the dynamics of the industry sector, etc. This information gap in turn makes it difficult, if not impossible, for new account managers to evaluate small business loan applications in a fair and informed manner.

Likewise, the smaller the firm, the higher the incidence of a loan application being rejected. The smallest firms faced a loan rejection rate of 13.6 per cent—a far cry from the 2.5 per cent rate for larger firms.

Use of logistic regression analysis of the survey data provides more insight into what factors affect a small business owner's likelihood of having their loan application rejected. The most significant factors that increase the likelihood of having a loan rejected were high account manager turnover and fewer years of business experience (see Table 3). Small businesses with fewer than 20 employees were also more likely to have their loan

application turned down. Firms that are in the personal services sector, are owned by a female, bank at either CIBC or Scotiabank, or have experienced a deteriorating equity level in the past three years were also more prone to having their loan application rejected.

Firms that use more business or personal banking services at their main financial institution, such as account and deposit services, RRSPs, payroll processing, credit cards, etc, are the least likely to have had their loan application turned down. Credit union customers are also less prone to loan rejections.

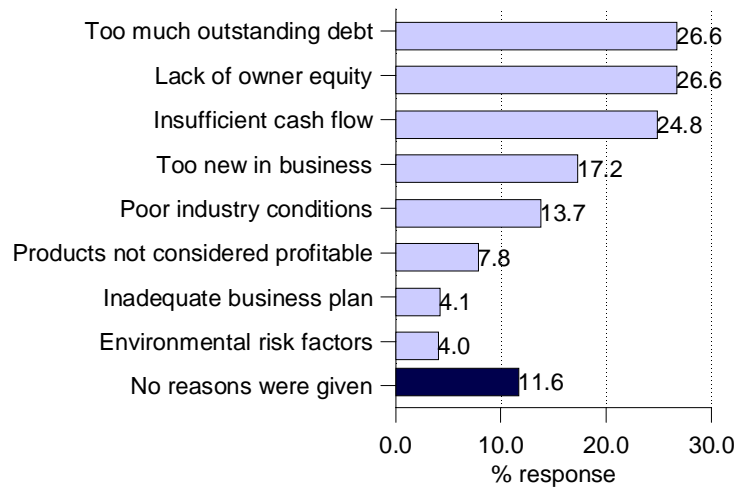
SMEs that use more banking services are the “least” likely to have their loan application rejected.

Table 3
Factors affecting the likelihood of having a loan application rejected, results of logistic regression (significant to 0.05 level), descending order of significance

“More” likely to have loan application rejected	“Less” likely to have loan application rejected
<ul style="list-style-type: none"> ⇒ High account manager turnover ⇒ Fewer years of business experience (10 years or less) ⇒ Small-sized businesses (under 20 employees) ⇒ Personal services sector ⇒ Female owner ⇒ CIBC client ⇒ Deteriorating equity levels ⇒ Scotiabank client 	<ul style="list-style-type: none"> ⇒ Use more “business” banking services ⇒ Use more “personal” banking services ⇒ Credit union client

Financial institutions cannot be expected to approve of every single application for financing. Nor should they. In most cases, the lending institution stated a reason for the decision. One-in-four respondents cited all too much outstanding debt, lack of owner equity and insufficient cash flow as the key reason for the loan turndown (see Figure 6).

Figure 6
Reasons for financing application being rejected



What is disturbing, however, is that 11.6 per cent of business owners were not provided a reason by their financial institution for rejecting their loan application—a direct violation of the Code of Conduct for the chartered banks. Of this group of respondents, only one-in-four indicated that local branch personnel made the final decision with respect to their loan application. Bank staff based in either the head or regional office played the largest role in deciding against loan applications, at 36.1 per cent. Automated credit scoring systems were also used to a great extent, at 8.3 per cent. The remaining 30.6 per cent were not aware of who within their bank turned down their loan application.

To make matters worse, the majority of these respondents (79 per cent) who were not provided a reason were “growing” firms—most exceeding 20 per cent revenue growth over the past three years. The implications of this practice are severe. Under serving the financing needs of this segment of the business sector can only result in sub-optimal growth in the economy. This signals the need for banks and other lending institutions to improve upon their internal procedures in cases where they decline applications for credit.

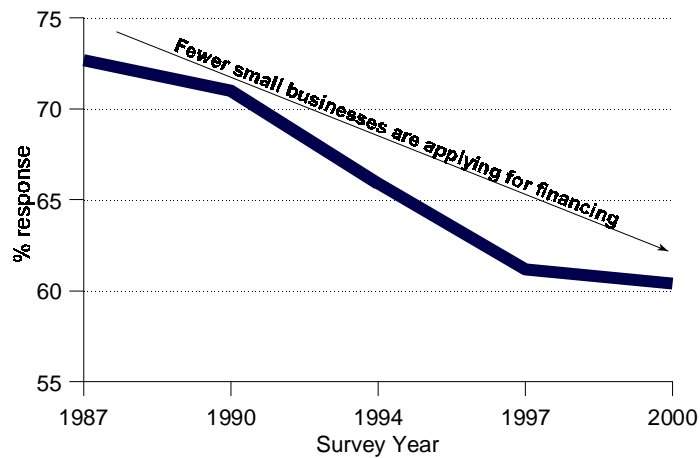
Loan Applications

(i) Incidence of loan applications:

Despite a strong economy, fewer and fewer small businesses are applying for financing. In 2000, only 60.4 per cent of business respondents applied for either a term loan, new line of credit or an increase in an existing line of credit in the past three years (see Figure 7). In 1987, the corresponding figure was significantly higher, at 73 per cent. This demand for financing tends to be higher for younger firms, at 65.8 per cent, compared to more established businesses, at 58.1 per cent. This difference of almost 7 percent is another indicator of the need to ensure that younger firms are able to obtain the necessary financing to prosper in the new economy.

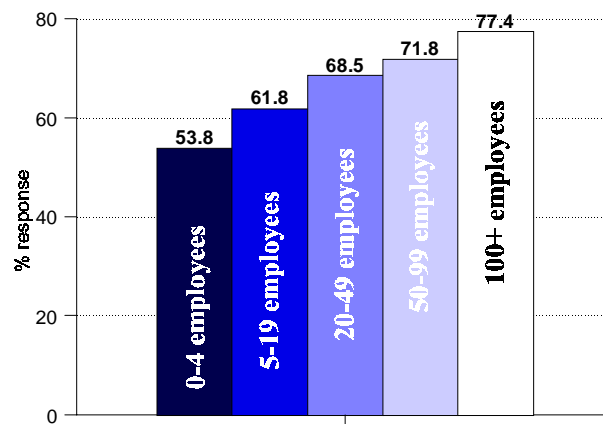
Despite a strong economy, fewer and fewer SMEs are applying for financing.

Figure 7
Share of SMEs that applied for financing in previous three-year period



This steady downward trend does not appear to be related to the business cycle. Whether the Canadian economy was in the midst of a recession in 1990 or expanded at healthy rates in the latter part of the decade, the proportion of businesses seeking financing continued to plummet. The combination of a weaker economy and credit cutbacks by financial institutions in the early 1990s may help explain this trend. However, the continuance of this trend throughout a period of strong economic growth raises serious concerns. It is particularly troublesome since it is more pronounced among the smallest firms where only one-in-two applied for financing in the past three years (see Figure 8).

Figure 8
Share of SMEs that applied for financing in past 3 years, by size of firm



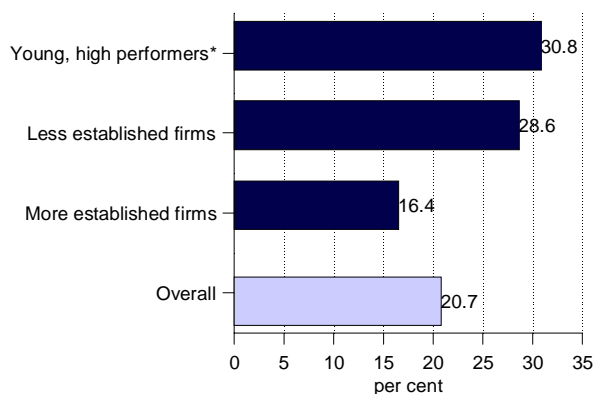
(ii) Underfinancing of SMEs:

Overall, one in five (20.7 per cent) firms were unable to obtain the necessary level of financing (see Figure 9). This underfinanced portion of the SME sector is comprised of firms that were in need of financing, but either had their credit financing application rejected by their banking institutions, were unable to obtain the full

One in five SMEs are unable to obtain the necessary level of financing.

amount of financing or were so discouraged that they did not even bother to apply for financing. Hence, this measure signals a much wider gap between the supply and demand for small business credit financing than the loan rejection rate mentioned above.

Figure 9
Share of SMEs that are underfinanced



* Respondents in business for 10 years or less who grew their gross sales revenue by more than 20 per cent during the past three years.

The magnitude of the underfinanced component of the SME sector differs substantially according to how long the respondent has been in business. The share of those less established firms that have been in business for 10 years or less is 28.6 per cent—significantly higher than the 16.4 per cent rate for the more established firms. However, the underfinanced portion of those less established firms with very strong revenue growth in the past three years is even higher, at 30.8 per cent. Hence, it is the young, high performing businesses that are experiencing the greatest difficulty in obtaining financing. These findings are quite troublesome. Not only does it compromise the growth potential of the small business sector, it limits the overall performance of the economy. Furthermore, the fact that the issue of access to financing is more severe among the smallest and youngest firms indicates that the job-creation ability for the vast majority¹ of businesses has yet to be fully unleashed.

It is the young, high performing businesses that are experiencing the greatest difficulty in obtaining financing.

Interest Rates

Business respondents pay an average of 1.53 percentage points above the Prime rate² for credit financing from their main financial institution (see Table 4). This holds true regardless of whether the type of financing was a term loan, a new line of credit or an increase/extension in an existing line of credit.

¹ The most recent Statistics Canada data indicates that 78.4 per cent of all businesses in 1997 employed fewer than five people.

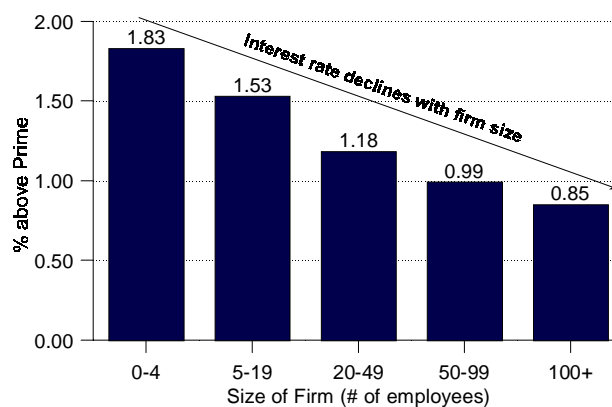
² During the survey period April-June 2000, the Prime rate charged by the major chartered banks rose to 7.5 per cent from 7.0 per cent.

Table 4
Interest rate over Prime, by type of financing and institution

Financial Institution	Term loans	New line of credit	Increase or extension in line of credit	Overall
Royal Bank	1.46	1.58	1.54	1.53
CIBC	1.39	1.36	1.17	1.33
Bank of Montreal	1.25	1.39	1.37	1.34
Scotiabank	1.57	1.34	1.26	1.42
TD Bank	1.25	1.21	1.21	1.25
National Bank	1.42	1.94	1.88	1.66
Credit unions	1.74	1.52	1.57	1.72
Caisse pop. Desjardins	2.51	2.90	2.36	2.57
Trust companies	1.13	2.19	1.67	1.84
Alta. Treasury Branch	1.93	1.94	1.63	1.75
HSBC	1.15	0.89	1.26	1.22
Other chartered bank	1.69	1.42	1.75	1.51
Other fin. Institution	1.88	1.47	1.97	1.64
TOTAL	1.50	1.53	1.47	1.53

HSBC offered financing at the lowest rates, while Caisse Populaire Desjardins charged the highest rates. This is understandable given that HSBC typically services larger, more established SMEs, while Desjardins caters more to the smaller, less established firms. Among the Big Six banks, the TD Bank offered the most competitive rates while the National Bank charged the highest.

Figure 10
Interest rate over Prime, by size of firm



The amount of interest above the Prime rate, however, varies according to firm size. On average, the smallest firms paid 1.83 per cent above Prime, while the largest firms paid 0.85 per cent over Prime—a difference of almost one full percentage point (see Figure 10).

Additional analysis through logistic regression techniques shows a variety of characteristics common among those businesses that paid more than 1.5 per cent above the Prime rate for financing (see Table 5). The most significant indicators in this respect are businesses that

Firms that applied for small loan amounts, had fewer years of experience or are small in size are more likely to pay high rates.

applied for small loan amounts (under \$100,000), have fewer years of business experience, and are small in size (less than 20 employees).

Where one does their banking also helps explain the incidence of high rates. Customers with Caisse Populaire Desjardins, Laurentian Bank, credit unions, National Bank, and the Royal Bank were more likely to pay higher rates. Similarly, several other factors are at play: deteriorating equity levels, personal services sector, Nova Scotia-based, Quebec-based, PEI-based, switched institutions recently or had high account manager turnover. Firms in the community services sector, agriculture sector or based in Manitoba had the lowest incidence of paying high rates.

Table 5
Factors affecting the likelihood of paying high interest rates, results of logistic regression (significant to 0.05 level), descending order of significance

“More” likely to pay interest rates more than 1.5% above prime	“Less” likely to pay interest rates more than 1.5% above prime
<ul style="list-style-type: none"> ⇒ Small loan amount ⇒ Fewer years of business experience ⇒ Small-sized businesses (under 20 employees) ⇒ Caisse populaire client ⇒ Laurentian Bank client 	
<ul style="list-style-type: none"> ⇒ Credit union client ⇒ Deteriorating equity levels ⇒ Personal services sector ⇒ Nova Scotia-based ⇒ National Bank client ⇒ Royal Bank client ⇒ Quebec-based 	<ul style="list-style-type: none"> ⇒ Community services sector ⇒ Agriculture sector
<ul style="list-style-type: none"> ⇒ PEI-based ⇒ Switched institutions recently ⇒ High account manager turnover 	<ul style="list-style-type: none"> ⇒ Manitoba-based

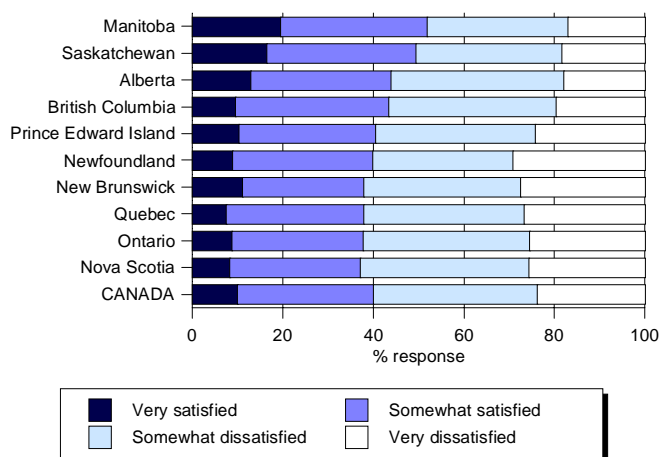
Service Charges

Beginning in the 1980s, financial institutions started to place greater emphasis on charging their clients a fee for certain types of services. Initially, pricing strategies were focused primarily on packages of services. In the 1990s, however, the strategy shifted to pricing each individual service. Today, the pricing strategies include a mix of individual services or bundled services. While there may be greater choices of service packages for small business owners, it does make it rather difficult for them to obtain information on certain individual service fees or service packages. Without such information, entrepreneurs are unable to make the most appropriate decision as to which package best suits their needs and pocket books. Moreover, business owners may be placed at a disadvantage when it comes to negotiating lower fees with their financial institution.

Overall, only 40.1 per cent of small business respondents indicated they were either “very satisfied” (10.0 per cent) or “somewhat satisfied” (30.1 per cent) with the service charges at their main financial institution (see Figure 11). Respondents based in the Atlantic provinces, Quebec and Ontario cited the lowest levels of satisfaction with service charges, whereas those in the four western provinces cited higher satisfaction levels in the 43 to 52 per cent range. The highest satisfaction levels are in Manitoba and Saskatchewan, which can be attributed to the prominence of credit unions.

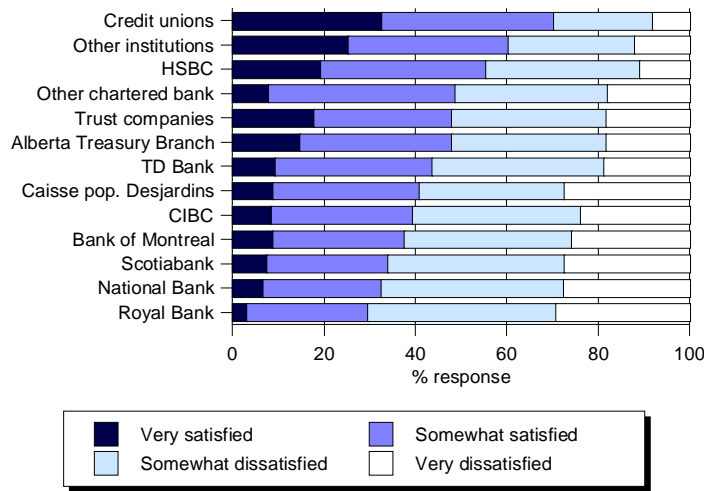
Only 40 per cent of respondents are satisfied with the level of service charges.

Figure 11
SMEs’ satisfaction with Service Charges, by province



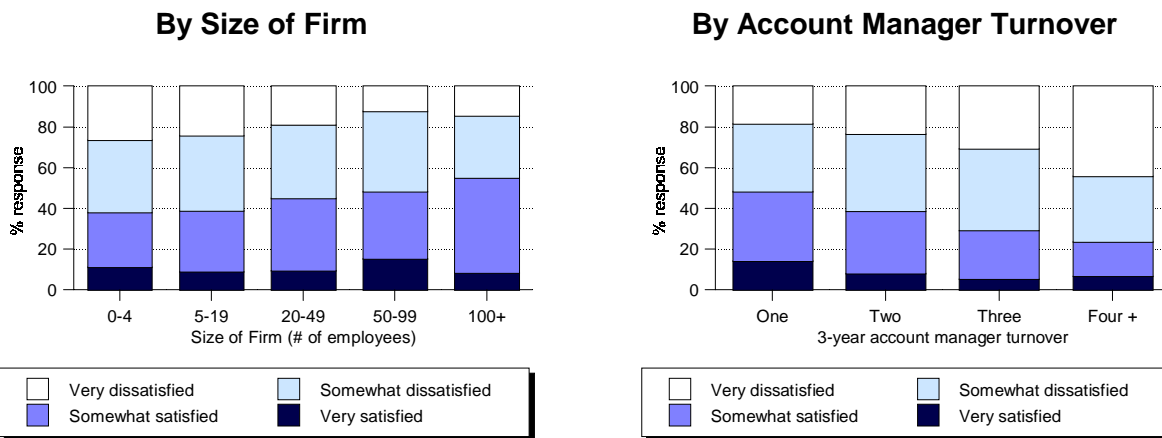
This corresponds to the survey finding that credit unions received the highest level of satisfaction by business respondents, at 70 per cent (see Figure 12). Business clients with HSBC, trust companies and TD Bank expressed above-average levels of satisfaction with service charges, while those with Desjardins and CIBC had average levels of satisfaction. The remaining major banks rated the lowest, with less than 30 per cent of Royal Bank clients expressing some degree of satisfaction.

Figure 12
SMEs' satisfaction with Service Charges, by financial institution



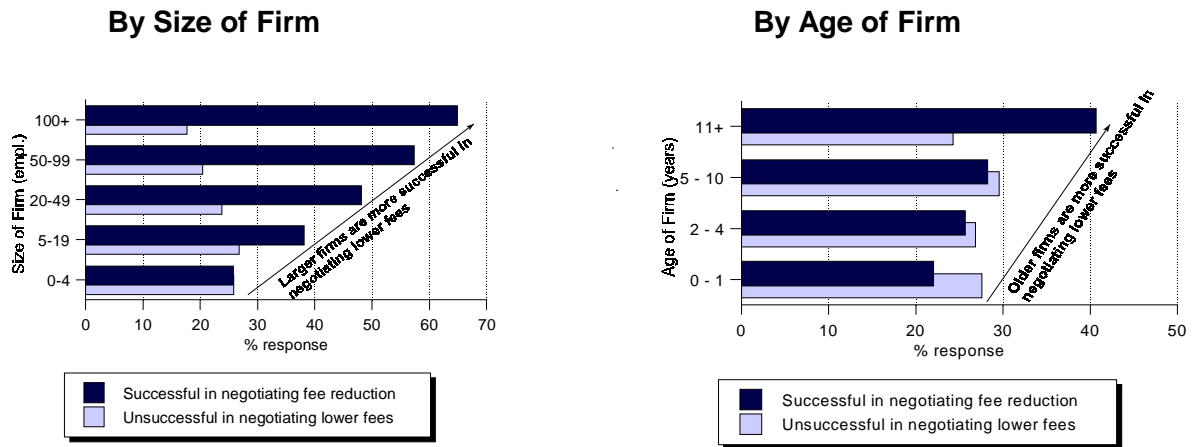
Consistent with previous CFIB research, the level of satisfaction with service fees is related to the size of the firm: the smaller the firm, the lower the level of satisfaction (see Figure 13). Similarly, the higher the account manager turnover rate, the lower the level of satisfaction.

Figure 13
SMEs' satisfaction with Service Charges



The larger the firm, the greater bargaining power with their financial institution. Two-thirds of respondents with a staff of 100 or more were able to negotiate lower service fees (see Figure 14). Unfortunately, the success rate declines with the size of the firm, with only one-in-four of the smallest firms indicating they were successful in bargaining for reduced fees. The same relationship was found among the age of the firm. The longer a firm has been in business, the higher success rate in lowering financial service charges.

Figure 14
Success in Negotiating Lower Service Charges



Competitive Forces

“We believe that Canadians will be best served by a dynamic, competitive marketplace, open to the world, with many successful Canadian providers and with opportunities for many new entrants. We believe that individual Canadians and small businesses, in particular, are not as well served as they should be and could be.”

Source: Report of the Task Force on the Future of the Canadian Financial Services Sector: *Change Challenge Opportunity*, Finance Canada, September 1998.

Central to the vision of the federal Task Force on the Future of the Canadian Financial Services Sector is the need to ignite competition among all providers of financial services to the small business sector. The Task Force put forth recommendations aimed at increasing competition. Many of the key recommendations put forth by the Task Force were aimed at allowing credit unions/caisse populaires and foreign banks to become more vigorous competitors.

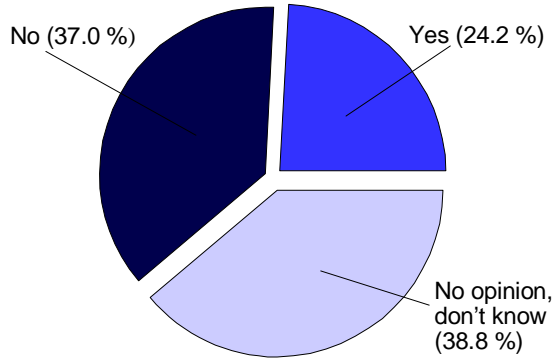
Small business owners, however, are not quite as optimistic as federal policymakers when it comes to believing that competition in the Canadian market will intensify due to new entrants.

Only 1 in 4 respondents view foreign banks as a viable banking alternative.

Only one-in-four respondents (24.2 per cent) expect foreign banks to become a viable banking alternative for their business within the next three years (see Figure 15). More than one-third of respondents (37.0 per cent) do not

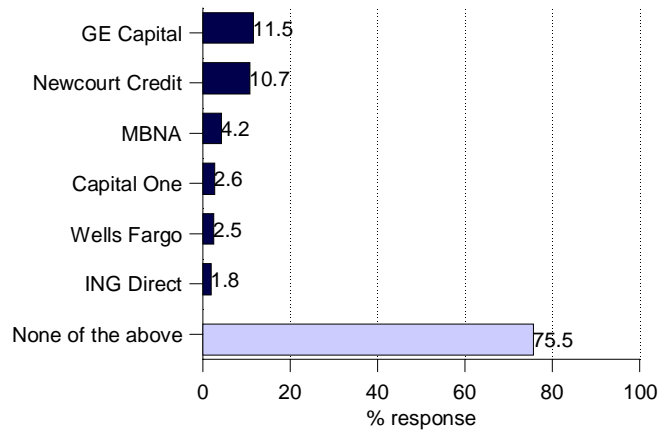
anticipate foreign banks will become real competitors in servicing the SME market, while the remaining respondents either have no opinion or don't know.

Figure 15
SMEs' views on whether foreign banks will become viable banking alternatives for their business within the next 3 years



The explanation for these findings is likely related to the limited presence of foreign institutions currently in the Canadian small business market, particularly in the non-urban localities, and the low use of specialty capital financing corporations. Only about one-in-ten respondents have “ever” used the services of GE Capital and Newcourt Credit (see Figure 16). Significantly lower responses were found among US-based credit card issuers MBNA (4.2 per cent) and Capital One (2.6 per cent). Foreign on-line banks Wells Fargo and ING Direct also have a very limited presence in the Canadian small business market. It is important to note that these financing sources are highly specialized and, therefore, do not represent a full banking service alternative to the SME sector.

Figure 16
SMEs' use of major specialized financial institutions

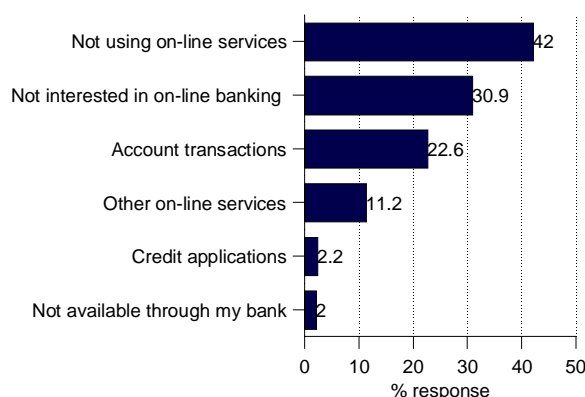


Overall, more than three quarters of respondents have never used the services of these six major financial service providers. Understandably, the fact that these institutions have yet to penetrate the domestic small business market that is dominated by Canada’s major chartered banks helps to explain the low expectations among small business owners for foreign banks to become potential competitors.

On-line Banking

Throughout the past decade, banks and other financial institutions have taken steps to “branch out” through electronic means. Whether this entailed the use of automated teller machines (ATMs), telephone banking, smart cards which can be used to store and spend cash, or Internet-based banking services, the overall objective was to offer greater convenience and constant availability to banking services. The problem with these types of delivery channels, including the Internet, is that the range of services is restricted. Less than one-in-four (22.6 per cent) business respondents use on-line banking for basic account transactions (see Figure 17). But while account funds can be accessed and transferred from one account to another, on-line banking generally does not offer many basic banking functions such as financing and cash management. This is evident in the finding that only 2.2 per cent of respondents applied for credit financing electronically.

Figure 17
Use of on-line banking services by SMEs

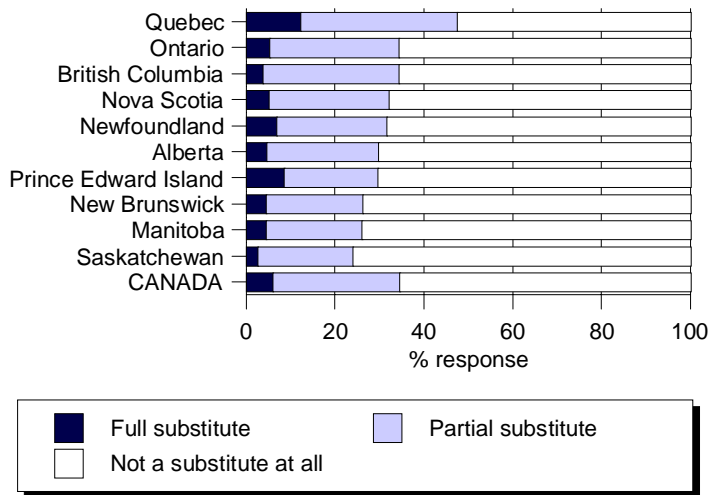


Considering the limited applications of on-line banking, it is not surprising that two-thirds (65.5 per cent) of respondents believe that on-line banking is not a substitute at all for branch banking, while 28.5 per cent felt it is a partial substitute (see Figure 18). Only the remaining 6 per cent view online banking as a full replacement for banking at a branch. Even among those respondents who currently use

Two-thirds of respondents do not believe that on-line banking is a substitute for branch banking.

on-line banking services, only 14.4 per cent view it as a full substitute for branch banking.

Figure 18
SMEs' views on the extent that 'on-line' banking is a substitute for 'branch' banking, by province



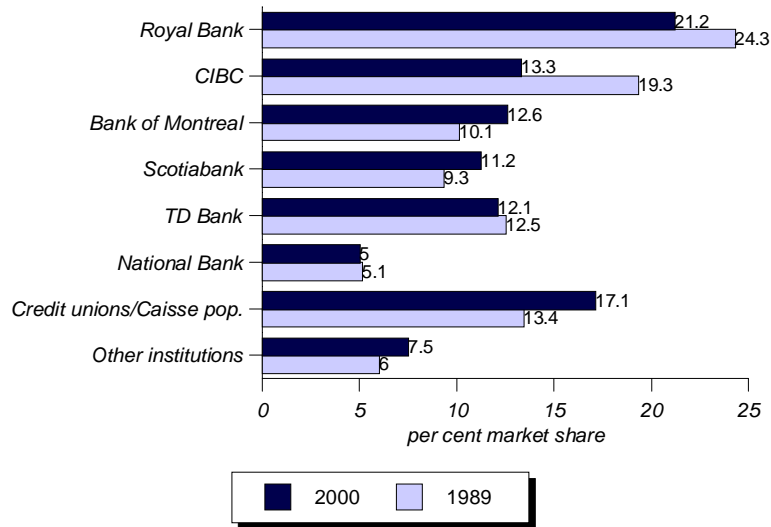
Quebec-based firms tend to have to a higher level of acceptance of on-line banking compared to the rest of Canada. Almost one-in-two respondents in Quebec view on-line banking as either a full substitute (12.3 per cent) or partial substitute (35.2 per cent). This is likely due to the more extensive usage of on-line banking services in Quebec, such as daily account transactions. The early introduction of debit cards by the Caisse Populaire Desjardins a decade ago also helps to explain this finding.

Market Shares

The market share for servicing the small business sector among institutions has changed significantly during the past decade. Most striking is the dramatic change in CIBC market share. In 1989, CIBC controlled 19.3 per cent of the small business market (see Figure 19). By 2000, however, CIBC's share was only 13.3 per cent. Royal Bank also lost a significant portion of the market, from 24.3 per cent in 1989 to 21.2 per cent in 2000. However, the Bank of Montreal and Scotiabank managed to gain some ground, with respective market shares of 12.6 percent and 11.2 per cent in 2000. TD Bank's share remained relatively stable at around 12 percent.

CIBC's and Royal Bank's share of the small business market fell dramatically during the past decade.

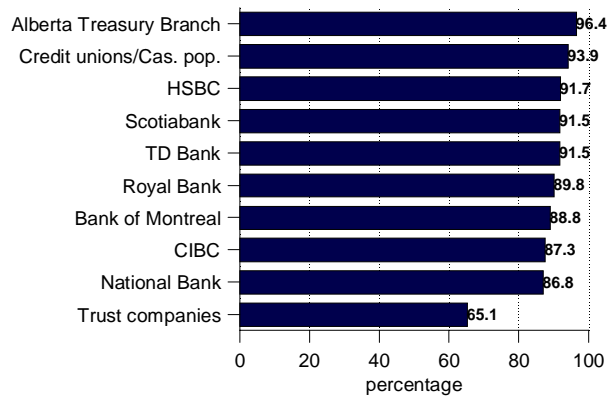
Figure 19
Small Business Market Share, 1989-2000



Sources: CFIB, *Banking Survey*, 2000 and *Our Members' Opinions Survey* No. 24, 1989. The latter was conducted through face-to-face interviews nationwide during January-June 1989 in which 18,994 responses were received from small business owners.

The market forces associated with operating a small enterprise in a competitive market requires the business owner to ensure that costs are kept to a minimum and that resources are spent in the most productive way possible. Choosing a supplier of financial services is no exception. If that supplier provides a high quality service at a competitive price, one would expect the client to remain loyal and not switch to a competing supplier.

Figure 20
Level of SME clientele retention* during the past three years, by institution



* The percentage of survey respondents who did not switch financial institutions between 1997 and 2000.

Sources: CFIB, *Banking Survey*, 1997 and 2000.

With respect to financial institutions, the level of SME client retention varies significantly. Alberta Treasury Branch (ATB) customers have the highest retention rate. During the past three years, ATB kept 96.4 per cent of its small business clients (see Figure 20). Clients with the credit unions and caisses populaires had the second highest retention ranking at 93.9 per cent. Retention levels among the major chartered banks fell in the 87 per cent to 92 per cent range. The low level for trust company clients reflects Scotiabank's acquisition of National Trust in 1997 and TD Bank's acquisition of Canada Trust earlier this year. With the exception of trust companies, retention levels are quite high for all institutions. The explanation for this finding may be related to respondents' relatively higher satisfaction levels with the services provided by financial institutions. As noted previously, however, a strong performing economy and SME sector are likely to have an upward bias on satisfaction levels. High retention levels may also be a result of a lack of any real alternatives for a respondent's current banking institution. To find examples of diminished choices for small business banking services, one need only look to the recent series of trust company acquisitions.

Overall, one in two respondents switched financial institutions because of poor service quality or lack of credit availability (see Table 6). Forty percent left because they were not satisfied with the level of service charges, and 23.7 per cent switched for more competitive rates. Branch closures were cited by 7.5 per cent of respondents as the reason for switching institutions.

“Service quality” and “credit availability” were the most commonly cited reasons for switching banks.

Table 6
Reasons for switching financial institutions between 1997 and 2000,
by bank used in 1997

Bank used in 1997	Service quality	Credit availability	Service charges	Interest rates	Branch closure
	(% response)				
Royal Bank	52.3	59.1	45.5	22.7	4.5
CIBC	53.7	63.4	41.5	31.7	4.9
Bank of Montreal	58.8	38.2	50.0	11.8	14.7
Scotiabank	75.0	62.5	31.3	6.3	0.0
TD Bank	45.0	85.0	30.0	35.0	5.0
Total	51.2	50.0	40.0	23.7	7.5

Note: Figures by bank reflect the views of 3,151 business owners that participated in both the 1997 and 2000 Bank Surveys. Responses are only shown for the Big 5 banks; figures are available for other institutions but the number of responses is too small to be considered statistically significant. Total responses are based on 10,024 responses to the 2000 Bank survey.

Sources: CFIB, *Banking Survey*, 1997 and 2000.

Conclusions and Recommendations

Entrepreneurship will no doubt form the foundation of a competitive Canadian economy in the 21st century. Individually, entrepreneurship can be strong. Collectively, it would create an invincible economic force for the nation as a whole. Whether it is embedded in a self-employed individual, a government department or a multinational financial institution, success in the new economy will be dependent on the collective effort of ‘all’ types of organizations to be more flexible, more determined, more imaginative...more entrepreneurial.

Critical to the future success of the SME sector is the ability of the banking sector to support entrepreneurial activity and to better serve needs of small business. The survey data indicates that there is a significant small business financing gap, particularly for the young, high performing SMEs. The top three factors attributed to high interest rates were small loan amounts, fewer years of business experience and very small firm size. Moreover, the smaller the firm, the lower the level of satisfaction with service charges. Part of the problem rests with a lack of financial institutions’ understanding of the younger, growing segment of the SME sector. This is, in large part, due to the high turnover rate of account managers.

Optimism is generally a natural trait of entrepreneurs. However, it is all but absent in terms of the role of foreign banks and on-line banking. Competition in the financial services sector is not expected to intensify due to relaxed rules for foreign banks to enter the domestic market—at least not for servicing the SME sector in any meaningful way. The limited applications and impersonal nature of on-line banking will hinder its proponents’ ability to use the Internet as a way to replace ‘bricks and mortar’ branches.

The past decade brought about significant changes in the market share for the SME sector among the major banks and other institutions. CIBC and the Royal Bank posted the largest losses, while the Bank of Montreal, Scotiabank and the credit unions gained ground. The TD Bank and the National Bank’s shares remained relatively stable. Small business owners continue to switch banking institutions for a variety of reasons. Poor service quality, lack of credit availability, and unfair service charge practices were the most frequently cited, followed by high interest rates and branch closures.

The announcement of the two bank mergers in 1998 placed the issue of competition in the Canadian financial services sector in the spotlight. This was not surprising given that so much was at stake. Allowing the Royal Bank to merge with the Bank of Montreal and CIBC with the TD Bank would have had dire consequences for all consumers of financial services. If given the “green light” by Ottawa, it would have resulted in 50 per cent or more of SMEs in all provinces, except Quebec, being served by only two mega-sized banks. In Ontario, the two newly merged banks would have immediately controlled 73 per cent of the small business market. Competition in the financial services sector would have been sacrificed at the expense of allowing the banks to have their way.

Clearly, there is a significant gap in the way the SME sector is treated by the banking sector. In an effort to help bridge this gap, CFIB offers the following recommendations:

- **Financial institutions should increase their participation in small business financing by adopting more innovative lending policies and practices.** Particular attention should be given to the young, high performing segment of the SME sector. This can be achieved by:
 - ⇒ modifying conventional SME loan application procedures to take into account more subjective criteria such as the applicant's character and commitment to repay loans; and
 - ⇒ providing more flexible loan repayment terms.
- **Financial institutions should enhance the role of the account manager at the branch.** This can be achieved by:
 - ⇒ reducing the turnover of account managers;
 - ⇒ ensuring that account managers are adequately versed in the needs of small businesses in the new economy; and
 - ⇒ providing account managers greater decision-making authority on loan applications.
- **Financial institutions should ensure that small businesses that are rejected credit financing are informed of reasons for the decision and are provided with information on financing alternatives.** The Code of Conduct for banks stipulates that these two actions must be carried out in cases of credit turndowns. However, the survey data clearly points to a gap in the implementation of this code.
- **Government policy should focus on increasing the level of competition in the financial services sector.** Such a strategy should include the following, as outlined by the MacKay Task Force:
 - ⇒ encouraging the development of competitive alternatives to the major chartered banks. This can be achieved by removing legislative and other regulatory barriers that impede the development of credit unions and foreign banks in the Canadian market; and
 - ⇒ establishing a clear set of criteria and public process to assess merger proposals among major Canadian banks.

- **Government should seek ways to rationalize their small business financing programs.** The role of government should be centered on collecting and reporting small business financing data on a regular basis.
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APPENDIX

Selected SME Debt Financing Indicators

- Table A1: by financial institution
- Table A2: by industry
- Table A3: by province
- Table A4: by age of firm

**Table A1:
Selected SME Debt Financing Indicators, by Financial Institution**

	Median financing approved	Market share* (loan value)	Market share* (customers)	Collateral-to-loan ratio	Interest rate over Prime	Loan rejection rate	Firms under-financed**	Firms with 3 or more account mgrs.
	\$	%	%	ratio	%	%	%	%
Royal Bank	100,000	17.0	21.2	1.41	1.53	10.8	19.9	23.6
CIBC	110,000	14.0	13.3	1.48	1.33	12.6	22.6	24.0
Bank of Montreal	150,000	16.7	12.6	1.42	1.34	10.9	21.7	27.0
Scotiabank	100,000	11.1	11.2	1.46	1.42	13.4	24.3	19.4
TD Bank	100,000	10.8	12.1	1.47	1.25	10.4	21.2	25.2
National Bank	150,000	6.6	5.0	1.03	1.66	8.6	19.8	31.5
Credit unions	74,000	4.7	8.7	1.52	1.72	6.6	13.9	7.3
Caisse pop. Desjardins	55,000	4.0	8.4	0.95	2.57	8.2	18.8	14.8
Trust companies	25,000	0.4	1.9	1.03	1.84	11.9	25.9	15.1
Alta. Treasury Branch	125,000	2.6	2.2	1.49	1.75	9.2	22.4	23.2
HSBC	500,000	7.4	2.0	1.35	1.22	8.3	14.2	23.7
Other chartered bank	500,000	1.9	0.4	0.89	1.51	9.4	25.0	17.2
Other fin. institution	100,000	1.2	0.9	1.64	1.64	7.1	19.3	6.5
TOTAL	100,000	100.0	100.0	1.38	1.53	10.5	20.7	21.9

* Market share figures differ significantly from province to province. In Quebec, for example, Desjardins accounted for 44.6 per cent of the small business market in 2000, while National Bank's held 22.9 per cent of the market. The Alberta Treasury Branch held 22.1 per cent of the small business market in Alberta.

** The underfinanced portion of the SME sector is composed of firms that were in need of financing, but either had their credit financing application rejected by their banking institution, were unable to obtain the full amount of financing or were so discouraged that they did not even bother to apply for financing.

**Table A2:
Selected SME Debt Financing Indicators, by Industry**

	Median financing approved	Market share (loan value)	Market share (customers)	Collateral -to-loan ratio	Interest rate over Prime	Loan rejection rate	Firms under-financed*	Firms with 3 or more account mgrs.
	\$	%	%	ratio	%	%	%	%
Agriculture	175,000	8.9	6.1	1.58	1.19	3.8	7.6	14.0
Primary	200,000	4.2	2.2	1.22	1.41	6.5	16.2	16.4
Manufacturing	184,000	25.3	14.8	1.32	1.49	8.5	18.2	22.9
Construction	100,000	7.1	10.2	1.34	1.51	9.1	20.1	20.5
Trans./communications	120,000	8.0	4.7	1.47	1.48	8.7	21.3	24.1
Wholesale	200,000	14.8	9.0	1.39	1.26	9.8	20.9	22.6
Retail	70,000	16.6	23.7	1.51	1.60	11.5	22.5	20.7
Finance, ins., real. est.	60,000	2.6	6.0	1.42	1.46	10.0	18.6	23.7
Business services	50,000	4.4	10.2	1.14	1.52	13.2	22.5	26.5
Community services	60,000	1.3	3.6	1.19	1.34	9.4	15.9	28.6
Hospitality/pers. services	76,500	5.4	9.5	1.33	1.95	16.6	28.7	20.9
TOTAL	100,000	100.0	100.0	1.38	1.53	10.5	20.7	21.9

* The underfinanced portion of the SME sector is composed of firms that were in need of financing, but either had their credit financing application rejected by their banking institution, were unable to obtain the full amount of financing or were so discouraged that they did not even bother to apply for financing.

**Table A3:
Selected SME Financing Indicators, by Province**

	Median financing approved	Collateral- to-loan ratio	Interest rate over Prime	Loan rejection rate	Firms under- financed*	Firms with 3 or more account mgrs.
	\$	ratio	%	%	%	%
British Columbia	140,000	1.67	1.30	9.1	17.7	20.2
Alberta	125,000	1.52	1.47	9.0	17.2	22.2
Saskatchewan	80,000	1.12	1.50	9.4	15.5	15.5
Manitoba	100,000	1.53	1.18	7.1	14.8	16.3
Ontario	100,000	1.54	1.39	11.2	22.3	24.1
Quebec	100,000	0.88	1.98	9.9	21.0	23.3
New Brunswick	100,000	1.03	1.69	9.7	22.4	18.9
Nova Scotia	100,000	1.39	1.67	14.0	23.0	19.2
Prince Edward Island	92,000	1.26	2.19	12.1	20.7	6.1
Newfoundland	68,000	0.87	1.54	18.3	30.3	19.4
CANADA	100,000	1.38	1.53	10.5	20.7	21.9

* The underfinanced portion of the SME sector is composed of firms that were in need of financing, but either had their credit financing application rejected by their banking institution, were unable to obtain the full amount of financing or were so discouraged that they did not even bother to apply for financing.

**Table A4:
Selected SME Debt Financing Indicators, by Age of Firm**

Number of years in business	Median financing approved	Collateral-to-loan ratio	Interest rate over Prime	Loan rejection rate	Firms under-financed**	Firms with 3 or more account mgrs. %
0-10	65,000	1.19	1.78	16.0	28.6	26.2
11 or more	125,000	1.47	1.39	7.6	16.4	20.2
Young, high performers*	80,000	1.25	1.72	16.9	30.8	25.5
TOTAL	100,000	1.38	1.53	10.5	20.7	21.9

* Respondents in business for 10 years or less who grew their gross sales revenue by more than 20 per cent during the past three years.

** The underfinanced portion of the SME sector is composed of firms that were in need of financing, but either had their credit financing application rejected by their banking institution, were unable to obtain the full amount of financing or were so discouraged that they did not even bother to apply for financing.