CFIB

Ensuring Canada's Future Through More Effective Banking and Insurance Services

CFIB Statement to the Standing Senate Committee on Banking, Trade and Commerce

Catherine Swift, President
André Piché, Director of National Affairs

February 17, 2005

CANADIAN FEDERATION OF INDEPENDENT BUSINESS

Executive Summary

The ability for SME owners to achieve their goals is highly dependent on a strong, competitive financial services sector. Whether it be convenient access to banking services that are competitively priced or the availability of insurance that fits the needs and budget of small businesses, access to financial services is critical to the continued future success of the SME sector and to the health of the Canadian economy.

In his 1998 Task Force's review of the financial services sector, Mr. Harold MacKay concluded that there was at that time too little competition in the provision of banking services to the small business market. CFIB agreed with this assessment and, unfortunately, feels even more strongly about this issue today. CFIB survey findings show that the major banks have not yet demonstrated that they are better able to serve the SME market than they were in 1998. The overall level of competition in the banking sector has not increased in recent years—at least not in terms of servicing the small business segment of the economy. Banks continue to focus their efforts on increasing the number of ATMs—at the expense of fewer full-service branches.

The issue of Property and Casualty (P&C) insurance for small business is also a critical issue facing SMEs. Business insurance has been identified as a top issue of concern with CFIB members, not just with respect to high costs but also on the availability of business insurance policies tailored for the SME market. While there are some limited alternative means of financing some businesses without resorting to bank financing, there are no alternatives to business insurance. A business owner either obtains proper insurance coverage, or faces the consequences of not being properly insured. Depending on the specific business sector, government legislation, as well as lenders, often require a business to have specific insurance coverage. Hence, business owners really have no choice but to obtain business insurance, often at astronomically high premiums rates. The fact of the matter is that fair access to competitively-priced insurance and banking products are vital for the future success of Canada's entrepreneurs.

To help the banking and insurance sectors better serve their SME clientele, CFIB offers the following recommendations:

Banking:

- **The federal government should not allow major chartered banks to merge with each other given the current level of competition in the banking industry.**

- **The federal government should collect and report publicly additional information specific to the banking sector's competitive status.**

- **The banking Code of Conduct should be consistently enforced to ensure that, at a minimum, the existing measures are implemented and to develop additional standards designed to improve overall service levels to the small business community.**

Business Insurance:

- **The federal government should undertake a review of P&C insurance issues affecting the SME sector.**

- **Additional information and statistics should be collected and reported publicly on business insurance.**

- **The P&C insurance industry should work with government and the CFIB to develop and implement, in a timely manner, its own voluntary Code of Conduct to help improve the overall service levels to the small business community.**

Introduction

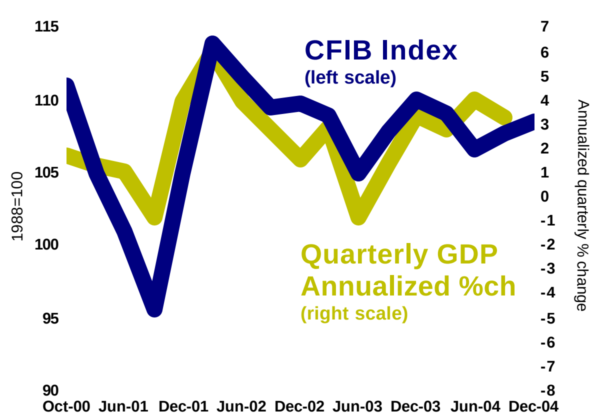
This brief is composed of four main sections. The first part outlines the importance of the SME sector to the overall economy. The second section deals with banking issues affecting the SME sector. Given the time constraints, however, we will not be presenting a comprehensive report on the banking industry. CFIB's views on banking issues are well documented. In fact, CFIB presented its views on bank mergers to this Committee on November 25, 2002. We will however highlight some key findings from our most recent review of the banking sector as we believe it is important to this Committee's deliberations. The third part of this brief focuses on the impact of business insurance issues on the SME sector. The final section outlines recommendations with respect to banking and insurance.

The SME Sector: Canada's Engine of Economic Growth

A strong small and medium-sized enterprise (SME) sector is the key to a successful, prosperous economy. Estimates based on Statistics Canada data indicate that Canada's SME sector accounts for close to half (43 per cent) of the gross domestic product (GDP)—a clear indication that all segments of the economy and society are affected in one way or another by small business. Despite the constantly changing business environment, the focus of Canada's entrepreneurs has never wavered: to take the initiative of starting and growing their own businesses and make a solid contribution to their communities in the form of jobs and economic growth.

The SME sector is a very accurate indicator of what is going on in the Canadian economy. Figure 1 highlights the CFIB Index that is based on survey data about our members' 12-month expectations for their own business and compares it to changes in the GDP. As the graph shows, there is a very close relationship between the two lines, which is hardly surprising since independent business owners report what they know best—their own business.

Figure 1:
SMEs—Barometer of Economic Growth



The SME sector is a very accurate barometer of Canada's GDP.

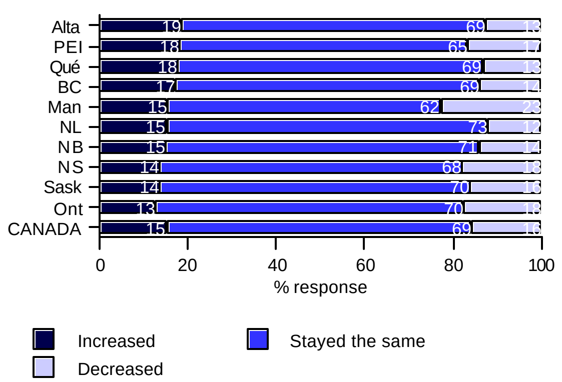
Source: CFIB, QBB, December 2004; and Statistics Canada

Unfortunately, some disturbing trends in Canada's financial sector have emerged during the past several years that have limited Canada's entrepreneurs in achieving their full potential. With respect to banking, there have been several failed merger attempts in the late 1990s by the major chartered banks. There is also the disturbing trend of bank branch consolidation throughout the country. In terms of public policy, the federal government has focused on developing merger review guidelines. The banks, however, have not demonstrated their ability to better serve their small business clientele. To the contrary, independent business owners have not seen any major improvement in banking competition. CFIB's October 2003 report "Banking of Competition" confirms this finding and points to the need for banks to better serve the SME market before government policy allows Canada's major banks to merge with each other.

Despite these efforts by the federal government to boost competition, not much has changed in the banking industry to better serve small business. In fact, for the vast majority of independent business people, the overall level of competition in the financial services sector in their local community has not changed in the past three years. Overall, survey respondents stated competition has either stayed the same (69 per cent) or decreased (16 per cent); only 15 per cent of business owners have seen competition rise (see Figure 2).

Figure 2:

Change in overall competition in banking industry during past 3 years (2000-02)



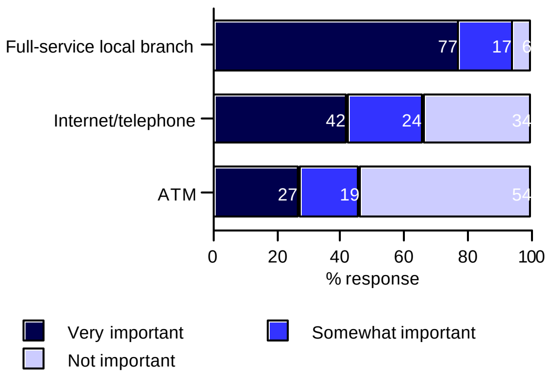
Despite efforts by the federal government to boost competition, not much has changed in the banking industry to better serve small business.

Source: CFIB, *Banking on Competition: Results of Banking Survey* (October 2003), based 9,565 responses

Since the 1980s, the banking industry has placed a heavy emphasis on changing the ways consumers and businesses conduct their banking. Automated teller machines (ATMs), the telephone and the Internet have all been used by the banks to steer their clients away from their local branch. In a broad sense, the banking industry's overall objective was twofold: (i) to offer their clients greater convenience and constant availability of services; and (ii) to lower their costs in delivering services. The banks have lowered their costs through mostly electronic service delivery, but to the detriment of many of their clients.

Business owners' preference in how they want to conduct their banking is straightforward: through a branch that is conveniently located and offers the full range of services essential to operating their business. More than three-quarters of respondents (77 per cent) stated that a full-service local branch is very important to running their business, while 17 per cent indicated it is somewhat important (see Figure 3). Only 6 per cent said access to a branch is not important. There is significantly less importance given to alternative banking methods, such as ATMs, the telephone and the Internet. This is because the range of services provided through these methods is restricted and do not allow access to basic banking services such as financing and cash management.

Figure 3:
Importance of methods of accessing banking services



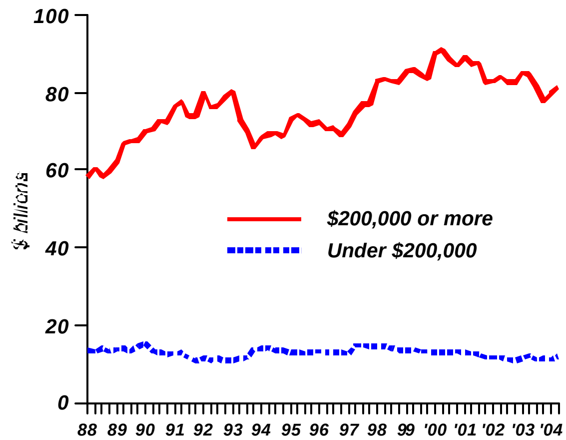
Access to a full-service local branch is by far the most preferred route to serving small businesses.

Source: CFIB, *Our Members' Opinions* Survey #56, preliminary data for January 2005, based 1,641 responses

The significance of the bank branch is even more evident for SMEs based in rural parts of Canada compared to those in urban centers. Eighty-six percent of SMEs in rural regions cited access to bank service at a locally-based full service branch is important to their business compared to 76 per cent respondents in urban centers. This is an especially troublesome finding given that banks have focused much of their branch consolidation efforts in rural parts of Canada.

According to Bank of Canada data, loan activity for amounts under $200,000 has remained stagnant but larger-loan activity of $200,000 or more has increased significantly (see Figure 4). Considering that the majority of small businesses that have loans/credit lines are for amounts under $200,000, aggregate bank loan activity for small businesses has not grown in the past few decades. In fact, adjusting the data for inflation shows that small-loan activity has actually declined since the 1980s, while larger-loan activity increased.

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

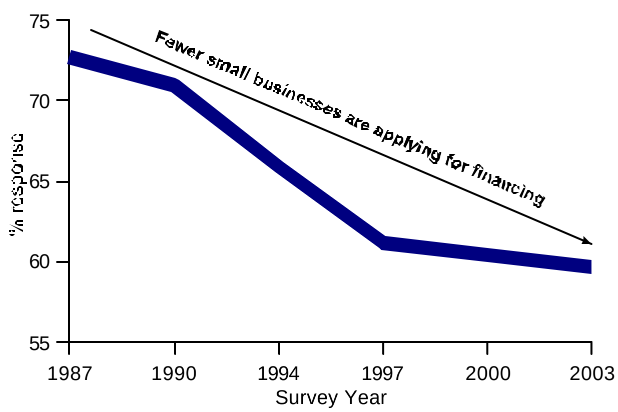


Small-size loan activity has remained stagnant while larger-loan activity has trended upwards.

Source: *Bank of Canada Review*, quarterly data, 1988 to 2004

The demand for bank financing within the small business sector continues to fall. Compared to previous years, fewer and fewer small businesses are applying for financing. Survey data from 2000 and 2003 shows that only 60 per cent of business respondents applied for either a term loan, new line of credit or an increase in an existing line of credit during the previous three-year period (see Figure 5). In 1987, the corresponding figure was significantly higher at 73 per cent. The low demand for financing is even more evident among very small businesses and firms in the retail and services-related sectors.

Figure 5:
Share of SMEs that applied for financing in previous three-year period (2000-02)



The demand for small business bank financing continues to decline.

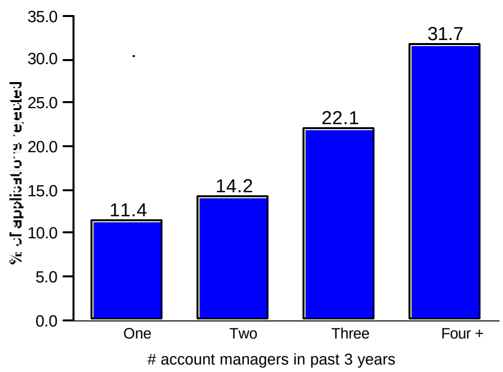
Source: CFIB, *Banking on Competition: Results of Banking Survey* (October 2003), based 9,565 responses

The decline in bank financing for the small business sector has been steady, without interruption since the late 1980s. Most importantly, fluctuations in the overall Canadian economy during this period do not appear to be a factor. One would expect the overall demand for small business bank financing to rise during high economic growth periods, and fall during times of low growth. But this relationship appears to be absent indicating that other factors are at play. A partial explanation is that during the recession in the early 1990s, the banks called in lines of credit to their small business clientele as a way to get their houses in order. As a result, those small business owners who were abandoned by their bank are reluctant to put themselves in that situation again.

The client-bank relationship is of paramount importance when it comes to loan applications being accepted or rejected. Simply put, the higher the turnover rate of account managers at the same bank, the higher the loan rejection rate. For example, close to one third (31.7 per cent) of businesses with four or more account managers in the past three years had their loan application turned down by their bank (see Figure 6).

Figure 6:

Loan Rejections Rates, by account manager turnover



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

Source: CFIB, *Banking on Competition: Results of Banking Survey* (October 2003), based 9,565 responses

Previous CFIB survey data has consistently demonstrated the importance of the account manager to various aspects of a bank's relationship with the small business client, particularly the strong correlation to the loan rejection rate and overall higher costs of financing. Unfortunately the survey data show that the major banks are still not retaining account managers with their small business clientele long enough to continue to build on the client-bank relationship. More and more small business owners must deal with far too many new faces at their bank. This is primarily the result of career opportunities within the bank provided to account managers or the multi-staff approach adopted by some banks. New account managers are not fully aware of the track record of the owner, the history of the business, the dynamics of the industry sector, etc. As a result, banks are not capable of fully understanding the specific needs of the small business client in order to evaluate loan applications in a fair and informed manner. The implications of high account manager turnover are far reaching, affecting virtually every major aspect of the bank-client relationship. Whether it is a loan rejection, high service charges, or higher bank financing costs, a small business has nothing to gain and everything to lose when its own bank keeps replacing their account manager.

The size of the business is also a major factor affecting the likelihood of a loan being rejected. In general, the smaller the firm, the higher the incidence of a loan application being rejected. For example, the loan rejection rate ranged from 23.3 per cent for the smallest businesses to 3 per cent for larger businesses.

The *smaller* the business, the *higher* the loan rejection rate.

A significantly smaller portion of the small business community is applying for bank financing and those that do apply are more likely to be turned down by their bank. A troublesome finding, however, is that 26.9 per cent of business owners were not provided a reason by their financial institution for rejecting their loan application. To exacerbate the situation, the vast majority of respondents (83.1 per cent) stated their bank did not offer any information on alternative financing sources. These findings indicate that the chartered banks are not adhering to the banking industry's own Code of Conduct.

The chartered banks are not adhering to their own voluntary Code of Conduct.

The implications of these findings are very significant. Why is a key segment of the economy—the SME sector—not seeking or obtaining bank financing for growth and expansion? Why are the major banks not fully adhering to their own Code of Conduct and offering appropriate financial information/advice to their own SME clients. Not only is the growth potential of the SME sector compromised by these findings, it will inevitably take its toll on the overall performance of the Canadian economy.

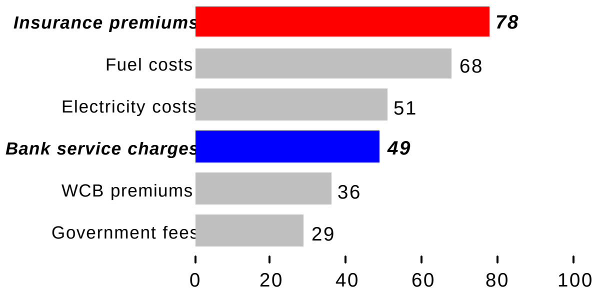
Insuring **the Future of SMEs**

With respect to insurance, it remains a top issue for small and medium-sized businesses across our nation. Rising insurance costs have become a major challenge for the majority of SMEs. CFIB has been addressing this issue over the past several years in order to better understand the nature of the problem, and provide some basic advice to business owners about protecting themselves. CFIB continues to hear from its members about their problems with business insurance on a weekly basis. Various CFIB surveys on insurance have confirmed that the cost of property and casualty (P&C) insurance has climbed rapidly and that the problem extends to all business sectors. Compared to all other major business input costs, insurance premiums rank #1 in terms of having a significant impact on small business (see Figure 7).

Figure 7:

Small Business Input Costs

Which of the following input costs is having a significant impact on your business? (% response)



Insurance premiums are the #1 input cost impacting SMEs.

Source: CFIB, *Our Members' Opinions* Survey #55, July-December 2004, based 19,555 responses

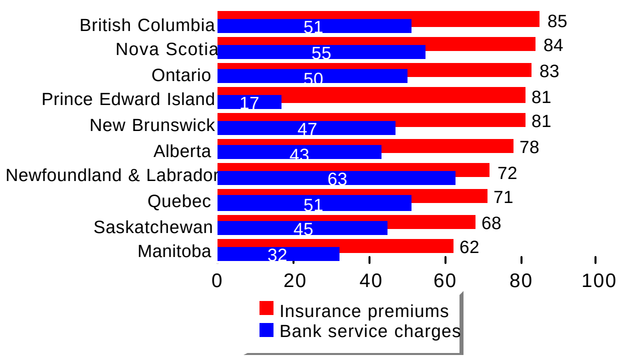
During the past few decades, the banks have honed their skills at raising more and more revenue by adopting a fee-for-service strategy. It is therefore no surprise that bank service charges are also a critical concern for one in two SMEs (49 per cent). Comparing the top two financial services input costs, insurance premiums outweigh bank fees in terms of impacting SMEs in every province (see Figure 8).

Figure 8:

Financial Input Costs: Insurance vs. Bank Fees

Which of the following input costs is having a significant impact on your business?

(% response)



Insurance costs outweigh bank services charges for SMEs in every province.

Source: CFIB, *Our Members' Opinions* Survey #55, July-December 2004, based 19,555 responses

The difficulties associated with bank financing and small business have been well documented in the recent past. CFIB has played a pivotal role in this regard. In addition, the work undertaken by Industry Canada in reporting publicly the results of the Statistics Canada survey on SME financing is also instrumental in helping to track banking issues affecting small business. Unfortunately, the high level of awareness and analysis on SME banking issues does not exist for business insurance.

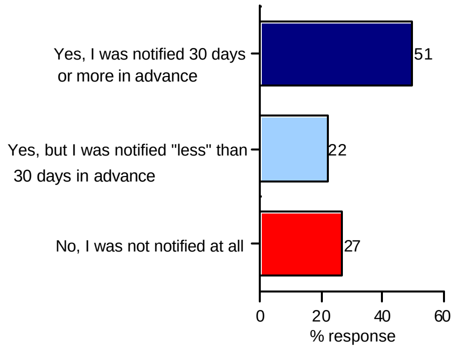
Many insurers have experienced significant financial challenges during the past several years. In general, the combination of significant increases in both the amount/value of insurance claims worldwide and poor investment performance have made the insurance market very difficult. CFIB is aware that these problems plaguing insurance markets are a worldwide phenomenon and that there are no instant solutions to solve the problem. However, given its significant impact on the Canadian economy, CFIB is continuing to address this issue in the best interest of its members.

CFIB believes that the key to addressing insurance-related issues in the future is to increase the overall level of awareness of the specific needs of the industry and its SME clients. The P&C insurance sector acknowledges that it needs to improve significantly its own understanding of the specific insurance needs of its SME clientele. While the Insurance Bureau of Canada has taken some steps to better understand small business, CFIB believes much more needs to be done.

Likewise, much more needs to be done to better understand how the insurance industry functions, particularly as it relates to business insurance. CFIB believes that an appropriate starting point to better understanding the P&C insurance market is the collection and publicly reporting of statistics on business insurance. We acknowledge that much information is available on personal auto insurance. In fact, the Bank of Canada recently identified rising personal auto insurance prices as contributing factor to inflationary pressures. This news eventually led to a review by Statistics Canada on whether the appropriate methods were being used in its reporting of auto insurance prices. The point being that even major government institutions do not have access to the appropriate level of statistics on insurance. CFIB is therefore recommending that additional information and statistics should be collected and reported publicly on business insurance.

There is currently insufficient statistics publicly available to adequately understand business insurance markets.

Figure 9:
Written notification in advance of all changes to insurance policy



Insurance companies are not adequately informing their SME clients when making changes to their policies.

Source: CFIB, *Insuring Your Business* survey, May 2002, based 8,200 responses

An additional concern on insurance is the lack of effective communications between the insurance companies and their SME clients. CFIB survey data shows that only one in two (51 per cent) independent business owners were notified in writing 30 days in advance of any changes made by the insurer to their insurance policy (see Figure 9). One in five (22 per cent) were notified in writing but received the notification less than 30 days in advance, while the remaining 27 per cent of survey respondents were not notified all. CFIB finds these figures are very troublesome as they signal a severe lack of communications from the insurance industry to their SME clients. The lack of communications can have direct consequences for many business owners if they are not informed sufficiently of any major changes to their insurance premiums or level of coverage. In some cases, the policy was cancelled with little warning or reasons leaving the SME client out in the cold to shop around for insurance coverage. As a result, CFIB is recommending that the Property & Casualty insurance industry should develop its own voluntary Code of Conduct to help improve the overall service levels to the small business community.

Conclusions and Recommendations

The role of public policy on financial institutions is now more important than ever. While banking issues are key concerns to many SMEs, insurance has become a top business issue for SMEs. Whether it is the rising cost of insurance, the lack of competitively-priced insurance products for the SME market, or access to bank financing, much needs to be done to improve conditions in the access to, and provision of, financial services to small business. CFIB believes that there are many ways to help improve the financial services market for SMEs. The following recommendations, if acted upon by the banking and insurance communities and government policymakers, would help in this respect:

Banking:

- **The federal government should not allow major chartered banks to merge with each other given the current level of competition in the banking industry.** There is currently insufficient competition in the banking industry and allowing bank mergers would only exacerbate the situation. The loss of the major trust companies, most recently Canada Trust, is a clear sign that mergers will only reduce the overall level of competition in the banking industry. (Please refer to CFIB survey question on bank mergers in the Appendix.)

- **The federal government should collect and report publicly additional information specific to the banking sector's competitive status.** While Statistics Canada and Industry Canada currently collect and report survey data on SME financing issues to the House Industry Committee on an annual basis, there currently exists a wide gap in pertinent information relating to competition and concentration levels within the bank sector. Examples include: the number and location of bank branches; types of service offerings on a branch basis; and the accessibility of banking services offered in various communities.

- **The banking Code of Conduct should be consistently enforced to ensure that, at a minimum, the existing measures are implemented and to develop additional standards designed to improve overall service levels to the small business community.** CFIB survey data indicate that one in four small businesses that are rejected for credit financing are "not" informed of the reasons for the decision and are not 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. The banking industry, in conjunction with government and CFIB, should work together to ensure the Code is being fully implemented and to develop additional banking standards to better serve the small business market.

Business Insurance:

- **The federal government should undertake a review of P&C insurance issues affecting the SME sector.** The purpose of the review would be to identify the problems facing the SME sector with respect to business insurance, and to identify ways of alleviating the problems. Such a review should also aim to answer the following: what are the overall impacts on the Canadian economy?; what are the impacts on SMEs and job creation?; what are the impacts on regional economies and exports?; Are government regulations set right and is there federal/provincial overlap?; and how can insurance rates be lowered?

- **Additional information and statistics should be collected and reported publicly on business insurance.** While much information exists on personal auto insurance, there is insufficient information available publicly on business insurance (e.g., commercial auto, property, liability, business interruption, etc.). The collection and publicly reporting of statistics on business insurance would help increase the overall understanding of the P&C insurance sector and allow the tracking and monitoring of markets trends in business insurance premiums and the availability of business insurance.

- **The P&C insurance industry should work with government and the CFIB to develop and implement, in a timely manner, its own voluntary Code of Conduct to help improve the overall service levels to the small business community.** Such a code should be on par with the Code of Conduct for banks and be based on the following four fundamental principles: the client's interest must come first; the right to be informed; the right to advance notice of any changes to an insurance policy; the right to redress. CFIB has outlined each of these key principles in a draft Insurance Code of Conduct (attached) that should be used by both the Insurance Bureau of Canada (IBC) and the Insurance Brokers Association of Canada (IBAC) and its provincial chapters to develop a Code suitable for improving the P&C insurance sector's ability to better service its small business clientele.

Canadian Federation of Independent Business

INSURANCE CODE OF CONDUCT: Key Principles from Canada's SME Sector

1. **The Client's Interests Must Come First**
    - The interests of the business owner as a client must have priority over the intermediary's interests and must not be sacrificed to the interests of others.

2. **The Right to Be Informed**
    - The business owner is entitled to full disclosure in plain language of the risks and benefits of the insurance package being offered, along with information about the intermediary's business relationships as they pertain to the transaction.

3. **The Right to Advance Notice**
    - Business owners need to be informed in writing no less than 30 days in advance when the price and/or terms of their insurance policy are to change and why.
    - Business owners need to be informed no less than 60 days in advance when the insurer will not be renewing an insurance policy at expiry and why.

4. **The right to Redress**
    - Insurers will ensure that a complaint resolution procedure is available for use by its SME customers that is on par with the Code of Conduct for banks. Insurers and intermediaries will provide SME customers with the information they need to access the complaint resolution procedure.
    - Each insurer will appoint a senior officer at the national level who is ultimately responsible for the resolution of complaints.
    - Insurers will respond to customer complaints as quickly as possible and inform the SME owner on when to expect a response to a specific complaint.
    - If a complaint is not resolved to the satisfaction of the SME owner, the insurer will provide written reasons justifying the insurer's decision.
    - The SME owner may then take the complaint to the General Insurance OmbudService where mediation services will be offered.
    - Insurers will make the following address available to their customers:

    Financial Consumer Agency of Canada (FCAC)
    427 Laurier Avenue West, 6th floor
    Ottawa, Ontario
    K1R 1B9

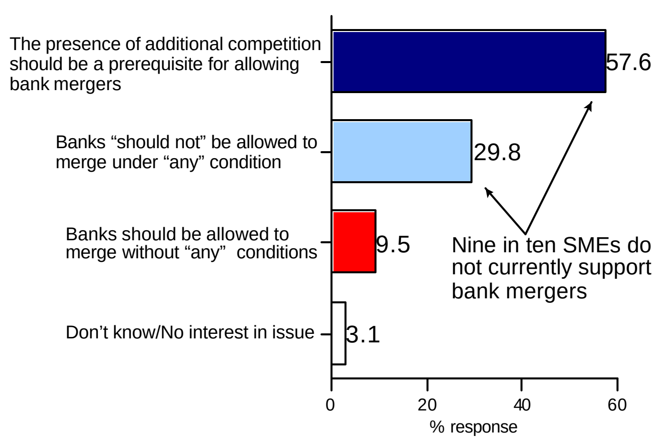
Should additional competition in the banking industry be a prerequisite for allowing major Canadian banks to merge with each other? (select one)

Background: Last fall, Scotiabank discussed a possible merger with the Bank of Montreal and, in 1998, there were two merger attempts—the Royal Bank with Bank of Montreal, and CIBC with TD Bank. To date, the federal government has rejected all proposed bank mergers, citing competition issues as a concern. The federal government did approve the merger between TD Bank and Canada Trust in 2000 and between Scotiabank and National Trust in 1997. There is a process in place to review proposed bank mergers through the Competition Bureau and the Office of the Superintendent of Financial Institutions. The final decision over bank mergers rests with the Minister of Finance based on public interest considerations that includes the costs and benefits to individual consumers and small business owners, as well as regional impacts and employment.

Supporters say there is currently insufficient competition in the banking industry and allowing bank mergers would only worsen the situation. The loss of the major trust companies has not been replaced by other competitive entities and foreign banks are not viable alternatives for most small businesses. Ensuring that competition in Canada's highly concentrated banking industry has increased before allowing bank mergers would be responsible public policy.

Opponents say the Canadian banking industry is competitive, but to protect consumers and small business in the long run, banks need to increase in size and pool their resources to offer the full range of banking services at competitive prices. A bank merger is simply a business strategy and Ottawa should not interfere in deciding what a bank's business strategy should be. Many other countries allow bank mergers as a way to strengthen their banking industry.

Results of Web Survey (n = 1,943)



The above survey question was conducted by e-mail on January 23-27, 2003. A total of 1,943 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 ±2.2 percentage points, 19 times out of 20.