Lending a Hand: An Exploration of Toronto's Values-Based Lenders, and the Role of Relationships in SME Lending

by

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Submitted to the Department of Urban Studies and Planning
in partial fulfillment of the requirements for the degree of

Master in City Planning

at the

MASSACHUSETTS INSTITUTE OF TECHNOLOGY

June 2019

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ABSTRACT

In the financial services industry, especially in the wake of the financial crisis, there has been a call for financial institutions to employ their capital for positive impact. While banks have traditionally worked to maximize value for shareholders, this movement has sparked interest in alternative banking models that incorporate social and environmental values. There are numerous names for this view of banking, among them, values-based, regenerative, ethical, sustainable, social, alternative, development and solidarity banking.

Many values-based institutions have smaller, more local footprints when compared to traditional banks, which makes them well-suited to lend to small and medium-sized businesses ("SMEs"). While SMEs are a vital component of any local economy, they often face challenges obtaining credit from traditional banks. There is an opportunity for values-based lenders to provide credit to SME borrowers that are unserved or underserved by traditional lenders, and in doing so support the social, environmental, and economic sustainability of local communities.

This thesis explores the current state of values-based lending to SMEs in Toronto, Canada. The Toronto financial market is dominated by a handful of large domestic banks; however, there is a gap between the credit requirements of SMEs, and what the traditional banking market is willing and able to supply. The author concludes that values-based lenders serve an important role in the Toronto SME lending market, filling numerous gaps left by traditional banks. These lenders are able to employ more qualitative, subjective and relationship-based methods in credit risk assessment and lending decisions.

Thesis Supervisor: Karilyn Crockett
Title: Lecturer of Public Policy and Urban Planning

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Acknowledgements

I owe a number of people thanks for their help with this thesis. A huge thank you to my advisor Karilyn Crockett, for your guidance, wisdom, and constant words of encouragement. To my reader, Katrin Kaeufer, for introducing me to the world of values-based banking, and for always being willing to help me work through my ideas. To all of the professionals who kindly granted me interviews, for making time to speak with me and educating me about your passions. To my classmates, for your ideas and friendship. Finally, to my friends and family, for all of your love and support throughout the process.

Table of Contents

CHAPTER 1: INTRODUCTION 6

CHAPTER 2: CONTEXT & LITERATURE REVIEW 10

2.1: Toronto SMEs and The Need for Financing 10
SME Environment & Financing Needs 10
Availability of Debt Financing for SMEs 11
The Regulatory Environment for Financial Institutions in Ontario 13

2.2: The Mechanics of Lending 15
Why Focus on Debt? 16
The Banking Business Model & Credit Risk 17
The Relationship Between Risk and Return 19

2.3: The Social Side of Banking 20
The Social Finance Market in Canada 20
Overview of Values-Based Banking 22
The Role of Relationships in Lending 25

CHAPTER 3: RESEARCH QUESTIONS & METHODOLOGY 30

3.1: Research Questions 30

3.2: Methodological Approach 31

3.3: Data Collection 32

CHAPTER 4: WHAT IT MEANS TO BE A VALUES-BASED LENDER 35

4.1: The Spectrum of Values-Based SME Lending in Toronto 35
i. Chartered Banks 37
ii. Credit Unions 38
iii. For-Profit Lenders 40
iv. Community Loan Funds 41
v. Government Institutions & Programs 42
vi. Alternative Lenders 43

4.2: What do Values-Based Lenders Look Like? 43
i. Purpose 44
ii. Character-Based Lending 45
iii. Social and/or Environmental Impact 46
iv. Provision of Non-Financial Services 47
v. Concern for Client Well-being 48
vi. Values-Aligned Procurement 49
vii. Marketing Appeal 49

4.3: Market Gaps 50
i. Access to Credit for Small Business 50
ii. Access to Credit for Charitable Sector, Co-operatives & Non-Profits 52
iii. Providing Financial Services to Vulnerable Populations 53
iv. Flexible & Long-Term Financing Solutions 54
v. Lack of Clear Funding Progression 55

4.4: The Role of Risk Perception & The Risk / Return Trade-off 55
Risk Perception 56
Risk/Return Trade-off for Values-Based Lenders 58

CHAPTER 5: THE IMPORTANCE OF RELATIONSHIPS 61

5.1: The Role of Relationships in Values-Based Lending 61

Formation of Relationships 61
The Use of Relationships in Assessing Credit Risk 62
The Use of Relationships in the Loan Approval Process 64
Client Relationships as Referral Source 66
The Need for Two-Way Relationships 67
The Downside of Relationship Lending 68

5.2 Lending Ecosystems: Networks of Relationships 69

i. Capital Ecosystems 70
ii. Customer Service Ecosystems 72
iii. Entrepreneurial Ecosystems 74

5.3: The Impact of Relationships on Credit Risk and Loan Losses 75

CHAPTER 6: TENSIONS, CONCLUSIONS & RECOMMENDATIONS 78

6.1 Key Tensions for Values-Based Lenders 78

i. Risk versus Government Regulation 78
ii. Scale versus Relationships 79
iii. Profitability for Investors versus Sustainability for Borrowers 81

6.2 Conclusions 84

Impact Measurement: An Area for Further Exploration 84
Answering the Research Questions 85

6.3 Key Takeaways & Recommendations 88

Limitations of Existing Values-Based Lenders 88
Recommendations 90
Implications & Future Considerations for Cities 92

APPENDICES 94

APPENDIX A: Interview Question Guide 95

APPENDIX B: Interviewees 97

BIBLIOGRAPHY 98

CHAPTER 1: INTRODUCTION

The level of social responsibility that should be assumed by the corporate world has long been the subject of debate. Milton Friedman famously wrote that, in a free economy, "there is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition, without deception or fraud."[1] Friedman felt that the use of corporate funds for the pursuit of social goals was akin to placing a tax on shareholders, and that decisions about the allocation of resources was best left to individuals and governments.[2] While this view, now referred to as "shareholder theory" lies at one end of the spectrum, "stakeholder theory" can be found closer to the other end. Stakeholder theory posits that companies must consider and balance the interests of all stakeholders, including shareholders, employees, customers, suppliers and communities, which may in turn reduce profits.[3] In this context, the term stakeholder can be understood to mean any entity that supports the wealth-creation of a business, or the parties who bear the risk of and/or stand to benefit from its operations.[4]

The idea behind stakeholder theory, namely that the pursuit of profit must be balanced with the needs of other stakeholders, is starting to gain traction in financial markets. On a global level, especially in the wake of the financial crisis, there has been a movement calling for banks to use finance as a force for positive social and environmental change. Depositors are starting to voice concerns about what their savings are being used for, and there is a heightened awareness of the risks associated with failure to consider the social and environmental impact of investments. As such, there is increased interest in the social and ethical potential offered by alternative banking models.[5] The specific terminology for this type of banking varies, but monikers include values-based, regenerative, ethical, sustainable, social, alternative, development or

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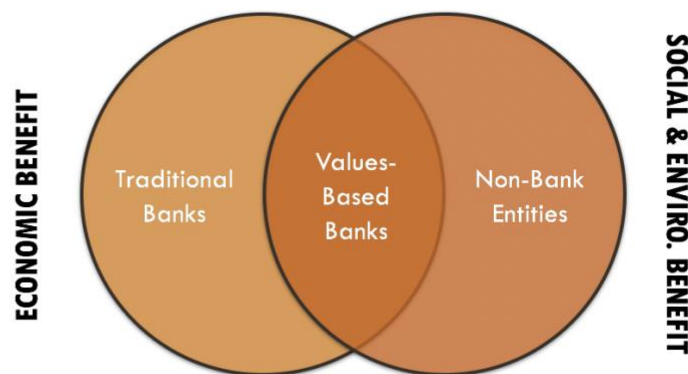
[1] Friedman, *Capitalism and Freedom*, 133.
[2] Friedman, "The Social Responsibility Of Business Is to Increase Its Profits."
[3] Smith, "The Shareholders vs. Stakeholders Debate."
[4] Post, Preston, and Sachs, "Managing the Extended Enterprise," 8.
[5] Climent, "Ethical Versus Conventional Banking: A Case Study," 2.

solidarity banking.[6,7] For the sake of simplicity, this thesis will refer to this model as "values-based" banking, and the institutions that embody these ideals as "values-based" lenders.

While traditional financial institutions are starting to consider more social and environmental factors in decision-making, as evidenced by the emergence of international standards such as *The Principles for Responsible Investment* and *The Equator Principles,* mainstream financial institutions continue to be driven by the short-term investment horizons of shareholders.[8] At least in the near term, true values-based banking will be undertaken by specialized financial institutions for whom ethics forms a core element of identity.[9]

Values-based banks operate according to a different business model when compared to conventional banks. Traditional banks consider only economic benefits, while values-based banks consider both economic benefits as well as social and/or environmental benefits.[10] For values-based banks, profit is one among several objectives, and one that ensures they remain operational; however, they also consider the needs of their other key stakeholders.

Figure 1: Considerations of Traditional vs. Values-Based Banks



[6] Korslund, "Real Economy - Real Returns: The Power of Sustainability-Focused Banking," 2.
[7] de Clerck, "Ethical Banking," 209.
[8] de Clerck, 210.
[9] de Clerck, 211.
[10] Banca Ética, "Finanzas Éticas."

Values-based banks focus on serving what is often referred to as the “real economy”, meaning the production of goods and services, versus more intangible and/or speculative capital markets activities. There is a wide range of how financial transactions are related to the real economy; some are completely disconnected, while others have much closer ties. For example, a loan extended to a manufacturing company is closer to the real economy than a derivative product created from the stocks of such a company. In order to stay as close as possible to the real economy, values-based banks place a greater emphasis on their deposit and lending functions. While large corporations may account for the bulk of lending assets at major global banks, small and medium sized-enterprises (“SMEs”) are a vital part of any local economy. One reason for this is that SMEs are the primary job creators in the economy, as well as the innovators. However, despite employing the bulk of the population, SMEs face significant challenges when it comes to accessing loans from traditional financial institutions.

While some SMEs have limited financial capacity and should not be able to take on debt, others are precluded from borrowing due to factors which may not be indicative of their ability to repay (e.g. lack of credit history, inadequate collateral, non-standardized operations). An opportunity exists for values-based lenders, who are not solely motivated by financial performance but have a stake in the success of local communities and businesses, to more effectively provide credit to SMEs.

This thesis will provide an examination of the current state of values-based lending to the Toronto SME market. Toronto is North America’s second largest financial hub, and is home to 800,000+ businesses and 38% of Canada’s corporate headquarters.[11] The SME debt finance market in Toronto is dominated by the “Big Five” Canadian domestic banks; however, there appears to be a gap between SME financing needs, and what these banks are willing and able to provide. The vast majority of Toronto SMEs requiring external financing rely on either trade finance or debt, and almost half of debt financing requests in 2017 were for credit cards bearing interest rates at almost three times those of more traditional loan products.[12]

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[11] Toronto Global, “Toronto Region Quick Facts.”
[12] Statistics Canada and Innovation, Science and Economic Development Canada, “Survey on Financing and Growth of Small and Medium Enterprises, 2017,” fig. 3,6,12.

This research will aim to investigate the importance of relationships between financial institutions and the customers and communities they serve, by linking the literature on relationship banking to the newly emerging concept of values-based banking. The primary intended audience of this thesis is the values-based banking community, both in Toronto as well as on a more global scale. A secondary audience, and direct beneficiary of this type of research, is the SME community in Toronto, especially those businesses who have had limited access to financing from traditional domestic banks. At a time when the banking industry as a whole is becoming more quantitative and technology-dependent, with the increased prevalence of online banking and algorithm-based lending, there is a need to recognize that relationships still hold value. At the end of the day, the business of banking is about serving the needs of people and communities.

CHAPTER 2: CONTEXT & LITERATURE REVIEW

The aim of this chapter is to delve more deeply into the financing challenges faced by SMEs in Toronto, and establish the potential for values-based lenders to serve their unmet needs.

2.1: Toronto SMEs and The Need for Financing

The following discussion will help to illustrate that while a large number of SMEs in Toronto require external debt financing, they face challenges when trying to obtain the necessary loans through major domestic banks and/or government programs.

SME Environment & Financing Needs

In Ontario, small and medium sized enterprises ("SMEs") comprise a large and extremely important part of the local economy. In Ontario, small (<100 employees) and medium (100-499 employees) sized enterprises account for 67.1% and 21.2% of private sector employment, respectively.[13] While some of these SMEs are able to meet their needs for financing internally with personal savings or support from family and friends, a significant number require external sources of funding to maintain and grow their operations.

In terms of government assistance, Toronto has supportive policies for small business development at multiple levels; however, most fall short of providing financing. At the municipal level, the city offers a number of resources to help small businesses, including free business plan reviews, operational support and resources to help businesses grow, and an entrepreneur mentor matching program.[14] Provincially, the Ontario Government funds the Ontario Network of Entrepreneurs ("ONE)", which provides numerous resources for people to start, grow or finance their businesses.[15] The Ontario Government recently partnered with Lending Loop, a peer-to-peer online platform, to help support the underwriting of small business

[13] Innovation, Science and Economic Development Canada, "Key Small Business Statistics," 12.
[14] City of Toronto, "Programs & Advice."
[15] Ontario Network of Entrepreneurs, "Ontario Network of Entrepreneurs."

loans.[16] At the federal level, the Canadian Government operates the Canada Small Business Financing Program ("CSBFP"), through which loans are made to small businesses with the risk shared by the federal government and commercial banks (government guarantees 85% of net losses). The aim of the program is to make loans to businesses that would not normally qualify in the private market, and 69% of the loans made through the program would not have been made in its absence.[17] However, financing under this program is only available for purchase of property, equipment or leasehold improvement, not for working capital purposes. According to a recent Statistics Canada survey of SMEs in Toronto, 65.5% of those that requested debt planned to use the funds for working capital / operating requirements.[18]

Based on a 2017 survey of Canadian SMEs (defined as enterprises with <500 employees and annual revenue of more than $30,000), 46.9% of the Toronto businesses surveyed requested external financing during the year.[19] The largest category of financing requests by Toronto businesses was trade finance (i.e. purchased on credit from suppliers), with 30.7% using trade credit financing in 2017.[20] Requests for debt financing made up almost half of requests for external financing (21.8%), and 12.8% of these requests were rejected.[21] Almost half of the business who applied for debt financing (9.7% of businesses) applied for credit cards, which bore average interest rates of 18% versus ~4-6% for other debt instruments (non-residential mortgages, lines of credit and term loans).[22]

Availability of Debt Financing for SMEs

While there is clearly a significant need for loans to SMEs in Toronto, the supply of credit for this segment from traditional lenders is quite limited. The Canadian banking sector is dominated by what are known as the "Big Five" domestic banks (Royal Bank of Canada, Bank of Montreal, Canadian Imperial

[16] Clare O'Hara, "Ontario Government Invests in Fintech to Boost Small-Business Lending."
[17] Rivard, "Incrementality Study of the Canada Small Business Financing Program," 17.
[18] Statistics Canada and Innovation, Science and Economic Development Canada, "Survey on Financing and Growth of Small and Medium Enterprises, 2017," fig. 7.
[19] Statistics Canada and Innovation, Science and Economic Development Canada, fig. 1.
[20] Statistics Canada and Innovation, Science and Economic Development Canada, fig. 12.
[21] Statistics Canada and Innovation, Science and Economic Development Canada, fig. 3.
[22] Statistics Canada and Innovation, Science and Economic Development Canada, fig. 4,6.

Bank of Commerce, Bank of Nova Scotia and Toronto-Dominion Bank), who have a cumulative C$4.8T in assets compared to the total asset base of ~C$5.5T for the entire Canadian banking sector in 2017.[23]

When compared to the rest of the country, the Toronto lending market is particularly concentrated among the major banks. In 2017, 89.8% of debt financing was provided by a domestic chartered bank (significantly higher than 69.9% nationally), while credit unions provided 2.8%, government institutions provided 7.9%, and online alternative lenders / crowdsourcing / peer-to-peer lenders provided 1.6%.[24] The breakdown of financing, specifically between domestic chartered banks and government programs, has shifted quite significantly in the past several years. As recently as 2014, domestic chartered banks were providing 96.7% of debt, while government institutions only provided 0.9%.[25]

This concentration itself isn't inherently bad, but it becomes an issue because many SME clients have a hard time getting financing from traditional banks. It is clear that domestic banks are still the largest provider of debt financing in the city. However, as indicated previously, a significant number of SMEs have their loan requests rejected, or have to rely on high interest credit cards to meet their financing needs. The most common reason lenders cited for declining financing requests was that the project was "too risky" (45.6%); other major factors included insufficient revenues/cash flow (38.6%), lack of collateral (31.1%), and lack of or poor credit (23.1%).[26] While the data accuracy of these particular statistics is marked by Statistics Canada as "mediocre" and/or "poor", the 2014 survey results confirmed these four factors as the major reasons for loan declines, with a higher accuracy level (largely "average" data quality).[27] Smaller businesses (those with fewer than 20 employees) had significantly lower debt approval rates than larger businesses (~80% versus 92%), due to lack of established credit, experience and assets.[28]

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[23] Fitch Solutions, "Canada Banking & Financial Services Report."
[24] Statistics Canada and Innovation, Science and Economic Development Canada, "Survey on Financing and Growth of Small and Medium Enterprises, 2017," fig. 2.
[25] Statistics Canada, "Survey on Financing and Growth of Small and Medium Enterprises, 2014," fig. 2.
[26] Statistics Canada and Innovation, Science and Economic Development Canada, "Survey on Financing and Growth of Small and Medium Enterprises, 2017," fig. 8.
[27] Statistics Canada, "Survey on Financing and Growth of Small and Medium Enterprises, 2014."
[28] Innovation, Science and Economic Development Canada, "Small Business Credit Condition Trends 2009–2016," 3.

The Regulatory Environment for Financial Institutions in Ontario

Lending infrastructure for financial institutions, comprised of elements such as the information, legal, social, tax and regulatory environments in a given jurisdiction, vary considerably across countries, but have a significant effect on credit availability for SMEs. This infrastructure helps to determine the legality and practicality of various lending technologies, which in turn determines which technologies are used in SME lending. Specifically, the regulatory environment imposes limitations on the structure of financial institutions, which can directly impact access to credit for SMEs.[29] In Canada, governance of financial institutions occurs at the federal and provincial levels, depending on the type of institution. The following discussion will focus on institutions that are relevant for purposes of this research.

The Federal Government is responsible for the regulation of all banks, trust and loan companies, and co-operative credit associations.[30]

- **Office of the Superintendent of Financial Institutions ("OSFI"):** OSFI, an independent government agency that forms part of the Financial Institutions Supervisory Committee ("FISC"), is a key player in the federal regulation of financial institutions.[31] OSFI is the entity responsible for the regulation of all domestic banks, foreign bank branches, trust and loan companies and cooperative credit companies.[32] In 2013, OSFI classified six of Canada's largest banks as "domestic systemically important banks" or "D-SIBS", meaning they must hold 1% more capital and are subject to more stringent monitoring and disclosure requirements than other banks.[33]
- **Financial Consumer Agency of Canada ("FCAC"):** Another member of FISC, FCAC is responsible for making sure that federally regulated financial institutions are abiding by

[29] Udell and Berger, "A More Complete Conceptual Framework For Financing Of Small And Medium Enterprises," 14.
[30] Ontario Securities Commission, "Canadian Financial Regulators."
[31] Ontario Securities Commission.
[32] Ontario Securities Commission.
[33] Canadian Bankers Association, "Focus: Global Banking Regulations and Banks in Canada."

consumer protection laws, and works to increase consumer education and awareness about their rights and responsibilities related to financial services.[34] FCAC ensures that banks abide by the "Model code of conduct for dealing with small and medium-sized enterprises", a code co-developed by Canadian banks and the Canadian Bankers Association ("CBA"), which serves to provide a minimum standard of service that SMEs can expect when trying to obtain credit.[35]

Provincial governments are responsible for the regulation of securities dealers, credit unions, and provincially incorporated trust, loan and insurance companies.[36] In Ontario, the following organizations are responsible for this provincial regulation:

- **<u>Financial Services Commission of Ontario ("FSCO"):</u>** FSCO is responsible for the regulation of credit unions and caisse populaires, loan and trust companies and co-operative corporations operating in the province.[37] For Ontario co-operatives, community bond issuances are governed by FSCO, who is responsible for reviewing and approving all offering statements prior to issuance.[38]
- **<u>Ontario Securities Commission ("OSC"):</u>** The OSC is responsible for securities regulation in Ontario, supervising any firms who trade and/or advise on securities, provide underwriting or investment fund management services, or trade in commodity futures contracts/options.[39]

Some of the values-based lenders interviewed as part of this project were not banks, credit unions, or co-operatives, but were in fact registered charities or non-profit organizations.

- **<u>Regulation of Charities:</u>** In Canada, registered charities are regulated by the Canada Revenue Agency ("CRA"), through the Income Tax Act.[40] Ontario also takes an interest in supervising

[34] Government of Canada, "Financial Consumer Agency of Canada."
[35] Government of Canada, "Small Businesses: Rights and Responsibilities."
[36] Ontario Securities Commission, "Canadian Financial Regulators."
[37] Financial Services Commission of Ontario, "About FSCO."
[38] Collins-Swartz, Interview by author.
[39] Ontario Securities Commission, "Who Needs to Register."
[40] Government of Canada, "What Role Does the Federal Government Play in the Regulation of Charities?"

charities at the provincial level, and the Office of the Public Guardian and Trustee ("OPGT") is tasked with "protecting the public interest in charitable property".[41] The CRA allows charities to run what it terms "related business", which are operated by volunteers or "linked" to its purpose; however, a lack of clear guidance about what constitutes a link causes confusion for charities wanting to operate social enterprises.[42]

- **Regulation of Non-Profits:** While charities and non-profits may appear to be similar, the two categories are mutually exclusive. According to the Government of Canada, charities can operate solely for charitable purposes, while non-profits can't operate for charitable purposes alone.[43] Non-profit organizations "can operate for social welfare, civic improvement, pleasure, sport, recreation, or any other purpose except profit".[44] Not-for-profit corporations can be incorporated either federally or provincially, depending on the scope of operations.[45] Federally incorporated non-profits are incorporated under the Canada Not-for-profit Corporations Act.[46] Provincially, the Ontario Not-for-Profit Corporations Act (expected to come into effect in 2020) will govern all Ontario not-for-profit corporations.[47] Similar to charities, CRA regulations mean that non-profits cannot operate for-profit social enterprises, even if any profit is reinvested into the operations of the non-profit.[48]

2.2: The Mechanics of Lending

Before trying to rectify the lack of credit availability for SMEs, it is first necessary to better understand the lending process, and how banks function more broadly.

[41] Ontario Ministry of the Attorney General, "Charities."
[42] Canadian Task Force on Social Finance, "Mobilizing Private Capital for Public Good," 21.
[43] Government of Canada, "What Is the Difference between a Registered Charity and a Non-Profit Organization?"
[44] Government of Canada.
[45] Government of Canada, "Not-for-Profit Guide."
[46] Government of Canada, "Are All Not-for-Profit Corporations the Same?"
[47] Ontario Ministry of Government and Consumer Services, "Guide to the Not-for-Profit Corporations Act, 2010."
[48] Social Innovation and Social Finance Strategy Co-Creation Steering Group, "Inclusive Innovation," 33.

Why Focus on Debt?

There are a number of options when providing capital to SMEs, including debt (e.g. loans, bonds), equity investments, and grant funding. This research project focuses on debt finance, as this is the asset class relied on by the majority of Canadian SMEs that require external financing. According to the 2017 Survey on Financing and Growth of Small and Medium Enterprises, 47% of Canadian SMEs required financing from an outside source. The bulk of SMEs (26%) relied on debt financing, as compared to 26% seeking trade credit, 7% lease financing, 4% government financing and 1% equity financing.[49] While there is a clear need for debt in the SME market, the attention of the financial community seems to be focused elsewhere. According to Craig Ryan, Director of Social Entrepreneurship at the Business Development Bank of Canada ("BDC"), the bulk of BDC's business is providing term loans and working capital.[50] This is what most small businesses actually need, but the financial industry doesn't find these products as interesting to talk about as venture capital and entrepreneurship.[51]

There is a clear link between values-based lending, and impact investing more broadly. The MaRS Centre for Impact Investing and Purpose Capital's 2014 study on the impact investing space in Canada defined impact investing as "investor and investee intention to create measurable positive impact beyond financial returns".[52] The report outlined six different asset classes that offer impact investment products, which included: cash/cash equivalents, private debt, public debt, public equity, private equity and venture capital.[53] Within Canada, private debt products are the largest impact investing product class (i.e. offer the highest number of investment products), but also have limited recognition.[54] On the whole, private debt

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[49] Innovation, Science and Economic Development Canada, "Summary of the Survey on Financing and Growth of Small and Medium Enterprises, 2017," 1.
[50] Ryan, Interview by author.
[51] Ryan.
[52] Karim Harji et al., "State of the Nation: Impact Investing in Canada," 10.
[53] Karim Harji et al., 37–39.
[54] Karim Harji et al., 41.

represents a relatively small volume of capital, because most of it is being placed by small community organizations with limited resources and fundraising ability.[55]

Although the private debt market, the area of interest in this research, may represent a small proportion of impact capital, this should not be confused with its potential for positive impact. It may be that the smaller scale of organizations making these loans, while limiting loan volumes, allows for a greater degree of long-term relationship building with borrowers and communities.

While each asset class comes with its own pros and cons, debt financing can be accompanied by the added benefit of improving a borrower's future access to capital. If an organization can demonstrate that they are able to make timely repayments on debt borrowed through a values-based lender, they may have an easier time borrowing through a traditional bank the next time around. While debt can be repaid, for an entrepreneur, equity financing ultimately means giving up a portion of their business.

The Banking Business Model & Credit Risk

As previously mentioned, the majority of debt extended to Canadian SMEs is done so by chartered banks. In order to understand how banks make their lending decisions, it is important to understand how they function more generally.

Banks act as intermediaries in financial markets, accepting deposits from savers on one side, and lending these same funds out to borrowers who require capital on the other. This concept, broadly termed "financial intermediation", involves an entity that enables the movement of capital from people or groups with surplus funds to those with a funding shortage.[56]

Banks face a number of different risks in their operations, which fall into the general categories of credit risk, market risk, liquidity risk, interest rate risk, foreign exchange risk, solvency risk, and operational risk. This investigation focuses on credit risk, which is defined as "the risk of losses due to borrowers' default or deterioration of credit standing".[57] Essentially, this is the risk that the bank will lose money if

[55] Karim Harji et al., 41.
[56] Golin and Delhaise, *The Bank Credit Analysis Handbook: A Guide for Analysts, Bankers and Investors*, 89.
[57] Bessis, *Risk Management in Banking*, 3.

borrowers are unable to repay their debts. According to the Basel Committee on Banking Supervision, the purpose of credit risk management is to maximize risk-adjusted return by ensuring a prudent level of credit risk.[58] For most banks, loans represent the major source of credit risk.[59]

Analysis of credit risk involves assessing the probability that a borrower will default, but also the level of uncertainty around this probability. Lenders ask for collateral or guarantees to protect against credit risk and uncertainty.[60] Although a number of factors affect credit risk of a borrower, the four most closely connected are: i) capacity/willingness to repay; ii) state of external environment; iii) features of credit product; and iv) adequacy of mitigating measures.[61] Among these, willingness to repay is a subjective metric based on qualitative information. All of these factors contribute to a lender's assessment of a borrower's credit risk, which ends up being a major driver of whether or not a loan is made, and what terms are attached to a loan.

In the past, local bankers relied less on formal credit analysis, and more on intuition and personal judgement rooted in an extensive knowledge of the community.[62] Bankers used to rely on more subjective characteristics to gauge credit risk on corporate loans, including borrower character, capital, capacity and collateral; however, through the 1980s and 90s banks moved towards more objective credit risk models based on accounting metrics to inform their lending decisions.[63] This process is arguably more efficient, as banks can make more loans, faster, with fewer employees. However, there are certain groups of borrowers that suffer more. As previously mentioned, SMEs tend to have fewer assets, lower revenues, and less sophisticated financial reporting, and they end up being penalized by these credit risk models even though they may not actually represent a higher credit risk.

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[58] Basel Committee on Banking Supervision, "Principles for the Management of Credit Risk," 1.
[59] Basel Committee on Banking Supervision, 1.
[60] Golin and Delhaise, *The Bank Credit Analysis Handbook: A Guide for Analysts, Bankers and Investors*, 6.
[61] Golin and Delhaise, 5–6.
[62] Golin and Delhaise, 9.
[63] Altman and Saunders, "Credit Risk Measurement," 1722.

The Relationship Between Risk and Return

The assessment of risk is clearly an essential component of the banking industry, but risk is not discussed in a vacuum. In the financial world, risk and return are two closely linked concepts. Risk in the context of finance is broadly understood as "the uncertainty over future asset values and future returns."[64] A high level of risk means more uncertain cash flows, and this uncertainty needs to be reflected in the value of an asset.[65] The financial concept of "risk-premium" is the incremental return required over the risk-free rate to compensate an investor for increased risk; investors demand higher returns for riskier assets. An asset is "risk-free" when there is no uncertainty in its future return (e.g. a treasury bill).[66]

Banks earn money on the spread between the interest rate paid to depositors for use of the funds, and the rate that borrowers are charged on loans. In doing so, banks are also bearing the credit risk of borrowers. The margin the bank earns through lending is essentially compensation for acting as the intermediary.[67] For lenders, the challenge is balancing the risk of the loan with its potential returns. If a borrower is perceived as higher risk, lenders charge them a higher interest rate, and generate more interest income. The key for banks is to try to make loans to these riskier borrowers, without inadvertently lending to someone who isn't going to pay them back. Pricing the loans, or determining the interest rate charged to borrowers, is a critical component of the lending process, as the rate must be both appropriate for the lender as well as amenable to the borrower.[68]

In modern financial markets, the concept of risk is starting to expand beyond just financial risk. The Governor of the Bank of England recently commissioned a Task Force on Climate-Related Financial Disclosures ("TCFD"). In 2017, this group published a report which included a number of recommendations for companies to disclose climate-related financial risks to stakeholders.[69] In addition,

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[64] Vernimmen et al., "The Risk of Securities and the Required Rate of Return," 297.
[65] Vernimmen et al., 301.
[66] Vernimmen et al., 315.
[67] Golin and Delhaise, *The Bank Credit Analysis Handbook: A Guide for Analysts, Bankers and Investors*, 88.
[68] Golin and Delhaise, 104.
[69] Williams and Wilkins, "How Environmental And Climate Risks And Opportunities Factor Into Global Corporate Ratings - An Update," 6.

according to S&P Global Ratings, there have been hundreds of cases over the past several years where environmental and climate ("E&C") factors have impacted corporate credit ratings.[70] E&C factors typically arise in relation to industry risk, competitive position, or management/governance.[71]

2.3: The Social Side of Banking

The above discussion relates to the banking industry as a whole, as opposed to values-based banking specifically. While the mechanics of lending generally remain the same, social finance involves the inclusion of additional goals beyond profit. It is still necessary to think about the trade-off between risk and return, but both of these concepts extended beyond just the financial realm.

The Social Finance Market in Canada

Canada has a rich history of social finance. The movement has recently been gaining increased momentum, especially over the past decade or so. In 2010, Social Innovation Generation ("SIG"), a partnership between The J.W. McConnell Family Foundation, MaRS Discovery District, PLAN Institute and the University of Waterloo, created a Task Force on Social Finance. The aim of the task force, comprised largely of executives from financial firms, venture capital funds and tech hubs, was to identify ways in which both for-profit and non-profit organizations could leverage private capital for social benefit.[72]

Almost a decade after this task force released its report, some progress has been made. In 2018, the government-backed Social Innovation and Social Finance Strategy Co-Creation Steering Group released a report, which made a number of recommendations to support social innovation and social finance in Canada.[73] Also in 2018, the Canadian Government pledged as much as $755 million over 10 years to create a Social Finance Fund, specifically targeted at investments which are unable to receive funding from the

[70] Williams and Wilkins, 1.
[71] Williams and Wilkins, 2.
[72] Canadian Task Force on Social Finance, "Mobilizing Private Capital for Public Good."
[73] Social Innovation and Social Finance Strategy Co-Creation Steering Group, "Inclusive Innovation."

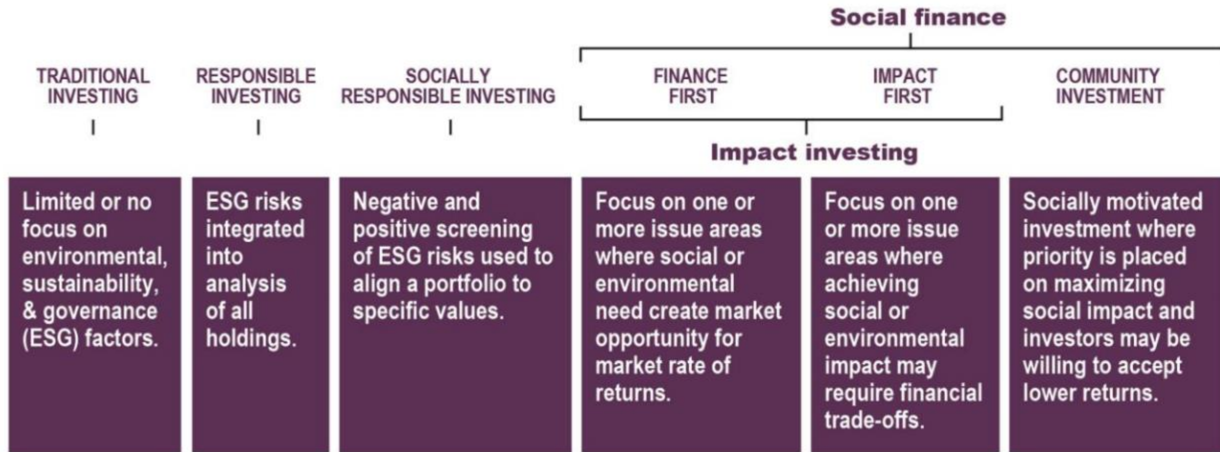
private market.[74] Along a similar vein, Ontario launched a Social Enterprise Demonstration Fund ("SEDF"), which provides funds to non-profits who can in turn provide social enterprises with funding and in-kind support.[75]

But what exactly does the term "social finance" mean? In its 2018 report, the Social Innovation and Social Finance Strategy Co-Creation Steering Group defined social finance as "investments intended to create a measurable social or environmental impact as well as to generate financial returns".[76] Social finance involves connecting individuals and organizations looking for capital (e.g. charities, co-operatives, social enterprises) to investors looking to create social or environmental impact through savings (e.g. foundations, pension funds, individuals), through intermediaries (e.g. banks, credit unions, community loan funds).[77]

However, even under the social finance umbrella, there is some variation. As illustrated in Figure 2, social investment classes differ in terms of the rates of return that they require for investors, and whether they are willing to accept lower than market financial returns in order to achieve greater social or environmental impact.[78]

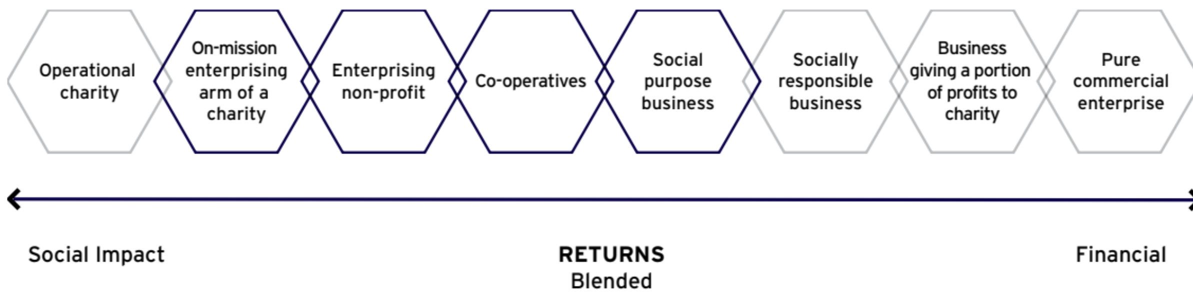
[74] SVX, "Canada Makes a Landmark $800 Million Commitment to Social Finance."
[75] Ontario Ministry of Economic Development, Job Creation and Trade, "Social Enterprise Demonstration Fund."
[76] Social Innovation and Social Finance Strategy Co-Creation Steering Group, "Inclusive Innovation," 13.
[77] Social Innovation and Social Finance Strategy Co-Creation Steering Group, 15.
[78] Social Innovation and Social Finance Strategy Co-Creation Steering Group, 14.

Figure 2: Forms of Investment. Source: Social Innovation and Social Finance Strategy Co-Creation Steering Group, 2018.



There is also considerable variation in the entities working to create social and environmental change, in this case forming the demand side of the social finance market. As seen in Figure 3, there are numerous types of organizations operating in the space, seeking varying combinations of social impact and financial return.[79]

Figure 3: Spectrum of Organizations. Source: Canadian Task Force on Social Finance, 2010.



Overview of Values-Based Banking

So far, this chapter has provided overviews of both the mechanics of banking, and the concept of social finance. The following discussion is an attempt to bring these two themes together, and focus specifically on the field of values-based banking.

[79] Canadian Task Force on Social Finance, "Mobilizing Private Capital for Public Good," 4.

According to the MIT Community Innovators Lab ("CoLab"), the concept of values-based banking is about the use of finance not just as an end, but as a means to tackle social and/or environmental issues.[80] This mandate must be ingrained into the business model of a financial institution, and as such auxiliary corporate social responsibility ("CSR") initiatives undertaken by a bank would not qualify. Central to the theory of just banking is the development of financial products and services that, beyond meeting financial needs, improve community well-being, and result in the establishment of long-term relationships with customers and populations.[81]

While literature has examined the concepts of "socially responsible finance" in terms of CSR and socially responsible investing ("CSI"), very little has been done to examine the role of banking and corporate finance in socially responsible finance.[82] Given that financial institutions are not guided or regulated regarding the social or environmental elements of their operations, bankers typically exclude these criteria from lending decisions, and instead apply what is referred to as the "neutrality rule". However, the argument that money can ever be "neutral" is untrue, as capital always has significant implications in terms of the social and environmental values it creates.[83]

A key force in the values-based banking movement is the Global Alliance for Banking on Values ("GABV"), a group of 54 globally located financial institutions with "a shared mission to use finance to deliver sustainable economic, social and environmental development, with a focus on helping individuals fulfil their potential and build stronger communities."[84] According to the GABV, values-based institutions aim to serve what is referred to as the "real economy", meaning those activities that actually produce goods and services versus the more intangible financial economy centred on capital markets.[85] As such, values-based banks have significantly higher lending activity than Global Systemically Important Banks

[80] "What Is Just Banking?"
[81] "What Is Just Banking?"
[82] Climent, "Ethical Versus Conventional Banking: A Case Study," 2.
[83] de Clerck, "Ethical Banking," 211.
[84] Global Alliance For Banking on Values, "About."
[85] Korslund and Spengler, "Strong, Straightforward and Sustainable Banking: Financial Capital and Impact Metrics of Values Based Banking," 1.

("GSIBs") (lending accounted for 75% of balance sheet vs. 42% for GSIBs in 2016), and much greater levels of deposits relative to their asset base.[86] GABV research has shown that values-based banks have had higher returns on assets ("ROAs"), comparable returns on equity (ROEs) and lower volatility from 2011-2016 than GSIBs.[87] The lower volatility of the values-based banks seems a logical result of the fact that their business model is grounded in lending (returns generated through recurring interest payments) than more cyclical and fee based capital markets activities.

According to the GABV, values-based banks operate according to six principles, which include: i) taking a triple-bottom line approach; ii) being anchored in communities and the real economy; iii) establishing long-term relationships with customers; iv) operating via a self-sustaining business model; v) ensuring transparent and inclusive governance; and vi) integrating all principles into the bank's corporate culture.[88]

Beyond these stated principles, the process by which values-based lenders grant credit to businesses may differ from traditional banks. In an empirical study that looked at the lending decisions made by commercial bank managers, it was found that the organizational pressures to maximize profits meant that banks were more likely to overestimate the risk of long-time customers as well as smaller customers (new clients and larger loans lead to greater profits and growth). In this situation, pressure from the organization overpowered the expected individual cognitive decision making process.[89] In the absence of an organization-level goal of profit maximization, it follows that values-based banking managers may make different lending decisions than those of traditional banks. If loans to small borrowers and long-time customers were appropriately risk rated, values-based banks might be able to make profitable loans that would otherwise not be made (or might be made on worse terms).

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[86] Korslund, "Real Economy – Real Returns: The Business Case for Values-Based Banking," 5.
[87] Korslund, 8.
[88] Korslund and Spengler, "Strong, Straightforward and Sustainable Banking: Financial Capital and Impact Metrics of Values Based Banking," 4.
[89] McNamara and Bromiley, "Decision Making in an Organizational Setting: Cognitive and Organizational Influences on Risk Assessment in Commercial Lending," 1083.

The Role of Relationships in Lending

As previously mentioned, the GABV's principles of values-based banking include the expectation that financial institutions be anchored in local communities and form long-term relationships with customers. As such, relationships between a lender and the customers and communities it serves is a key component to the theory of values-based banking.

What is Relationship Lending?

Small business lending can be broken down into transaction-based lending (including lending based on financial statements, asset base and credit scoring) which relies on "hard" information provided at the time a loan is made, and relationship lending, which uses "soft" information about a firm gathered over the course of the client relationship.[90] The theory of relationship lending, a concept often discussed in financial literature, is that banks build up a store of information over time through interactions with customers and community, and subsequently rely on this information to inform their lending decisions. In order to lend to small businesses, financial institutions need to find ways to deal with problems of informational asymmetry, namely moral hazard and adverse selection.[91] Small firms tend to be more "informationally opaque" than larger firms, as many do not prepare audited financial statements or have publicly traded debt or equity.[92] As such, small firms have a comparatively high information asymmetry barrier versus larger public firms.[93] Lenders address the problem of asymmetric information by collecting and analyzing information about their borrowers, but also by using the terms and conditions of a loan (i.e. interest rate, collateral requirements) to alter the incentives of the borrower.[94]

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[90] Berger and Udell, "Small Business Credit Availability and Relationship Lending: The Importance of Bank Organisational Structure," 36–37.
[91] Cole, Goldberg, and White, "Cookie Cutter vs. Character: The Micro Structure of Small Business Lending by Large and Small Banks," 227.
[92] Berger, Cowan, and Frame, "The Surprising Use of Credit Scoring in Small Business Lending by Community Banks and the Attendant Effects on Credit Availability, Risk, and Profitability," 2.
[93] Johan and Wu, "Does the Quality of Lender–Borrower Relationships Affect Small Business Access to Debt? Evidence from Canada and Implications in China," 206.
[94] Berger and Udell, "Relationship Lending and Lines of Credit in Small Firm Finance," 351.

Relationship lending is broad concept, and the theory applies just as much to traditional banks as it does to values-based lenders. However, values-based banks tend to have a local focus, amplifying the importance of relationships. As their loan portfolios tend to be higher risk, local operations allow them to have a deep understanding of the region and their customers.[95] Additionally, engagement of the local community is critical to linking their economic and values-driven mandates, and the place-based employment of capital.[96]

Impact of Relationships on Credit Terms

The connection between strong relationships and improved credit terms for SMEs is an important one to establish, as it speaks to the ability of values-based lenders to provide loans to SMEs.

The link between the length of a borrower-lender relationship and the interest rate charged has been debated, with various models predicting either a direct or inverse relationship between the two.[97] In an empirical test of such models in the US, it was found that small firms who had longer relationships with lenders tended to be charged lower interest rates, and were less likely to be required to pledge collateral.[98] This study also suggested that lenders collect private information about borrowers over the course of their relationship, and that this information informs changes to their loan terms.[99] Another US study found that relationships can improve credit availability and price (to a lesser extent) for small firms.[100] However, a study of Canadian firms found that the quality of a relationship between a lender and borrower (namely support during downturns, willingness to negotiate and turnover of bank contact) did not have a significant impact on access to or changes in terms of lending.[101] There is also empirical evidence that relationship banking can influence a borrower's financial outcomes after situations of financial distress. A study of US

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[95] Paulet, Parnaudeau, and Relano, "Banking with Ethics: Strategic Moves and Structural Changes of the Banking Industry in the Aftermath of the Subprime Mortgage Crisis," 202.
[96] Paulet, Parnaudeau, and Relano, 202.
[97] Berger and Udell, "Relationship Lending and Lines of Credit in Small Firm Finance," 352.
[98] Berger and Udell, 377.
[99] Berger and Udell, 377–78.
[100] Petersen and Rajan, "The Benefits of Lending Relationships," 34–35.
[101] Johan and Wu, "Does the Quality of Lender–Borrower Relationships Affect Small Business Access to Debt? Evidence from Canada and Implications in China," 210–11.

firms showed that for firms who issued "profit warnings" (negative information), those who had loans with relationship lenders (versus non-relationship lenders) had a lower probability of default and improved operational performance as banks stepped into a risk management role.[102]

A firm's relationship with a bank, in terms of duration and breadth, should theoretically reduce the cost of lending to such a firm; however, whether these savings translate into lower costs to the borrower is dependent on the level of competition in the market for small business loans, and the ability to transfer information to new lenders.[103] It has been theorized that lending relationships can create value for lenders, with their in-depth knowledge of borrowers essentially giving them temporary monopoly power against other lenders, allowing them to earn economic profits on existing borrowers.[104]

Apart from the interest rate effect of lending relationships, establishing deeper connections may also benefit lenders by reducing moral hazard problems among customers. An empirical study looking at borrowers at India's largest commercial bank found that those who received more personal attention from a bank relationship manager were less likely to default on loan payments, have fewer defaults, and have the first default occur later.[105] Similar patterns have been found in the credit card market; probability of default declines with increased breadth, depth and length of relationship.[106]

Are Small Businesses Best Served by Small Lenders?

The traditional wisdom was that small, local, community banks have the strongest relationships with small, informationally opaque businesses, as they can better collect and process soft information.[107] Small business loans have historically accounted for a larger percentage of assets at smaller banks versus their larger counterparts.[108] As the "soft" information used in relationship lending is collected by a loan

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[102] Donker, Ng, and Shao, "Borrower Distress and the Efficiency of Relationship Banking," 2.
[103] Petersen and Rajan, "The Benefits of Lending Relationships," 6.
[104] Sharpe, "Asymmetric Information, Bank Lending and Implicit Contracts: A Stylized Model of Customer Relationships," 1069–70.
[105] Schoar, "The Personal Side of Relationship Banking," 21.
[106] Agarwal et al., "Benefits of Relationship Banking: Evidence from Consumer Credit Markets," 5.
[107] Berger, Goulding, and Rice, "Do Small Businesses Still Prefer Community Banks?," 264–65.
[108] Cole, Goldberg, and White, "Cookie Cutter vs. Character: The Micro Structure of Small Business Lending by Large and Small Banks," 228.

officer and is difficult to verify or share with higher levels of management, relationship lending can cause an agency problem that may be addressed through small, flatter organizational structures.[109] One study applied Williamson's theory of organizational control to banks.[110] This theory posits that as an organization gets larger, the ultimate decision makers get further removed from actual operations; as information is transmitted over more hierarchical levels, it deteriorates in quality and quantity.[111] The parallel drawn by the authors of the study was that as smaller banks have fewer levels of hierarchy, relationship managers can have a greater degree of discretion when it comes to lending decisions, making them less likely to employ a "cookie-cutter" approach to lending decisions. Large banks, on the other hand, need to establish formal processes in order to maintain control over more levels of hierarchy, leading them to rely on more standardized financial factors in lending decisions.[112] The study found that there was a clear difference in the small business loan assessment process between large and small banks. Lending decisions at large banks were more likely to stem from financial factors, whereas decisions at small banks were more likely to be driven by relationship factors.[113]

While there is much historical evidence to support the view that small lenders are best suited to serve small businesses, the theory may no longer hold true, especially as financial markets increasingly turn to technology in the loan application process. According to one US study, community banks are not more likely to act as the main bank for small businesses, and that the strength of the borrower-lender relationship does not depend on bank type.[114] The authors of the study posit that this may be due, in part, to increased use of credit scores in small business lending.[115] Another study found that many US community banks do,

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[109] Berger and Udell, "Small Business Credit Availability and Relationship Lending: The Importance of Bank Organisational Structure," 48–49.
[110] Cole, Goldberg, and White, "Cookie Cutter vs. Character: The Micro Structure of Small Business Lending by Large and Small Banks," 229.
[111] Williamson, "Hierarchical Control and Optimum Firm Size," 126–27.
[112] Cole, Goldberg, and White, "Cookie Cutter vs. Character: The Micro Structure of Small Business Lending by Large and Small Banks," 229–30.
[113] Cole, Goldberg, and White, 249.
[114] Berger, Goulding, and Rice, "Do Small Businesses Still Prefer Community Banks?," 277.
[115] Berger, Goulding, and Rice, 266.

in fact, use credit scores when making lending decisions in order to combat the issue of information asymmetry. However, the study also found that community banks tended to supplement these credit scores with other methods (e.g. relationship lending), and that the use of credit scores increased availability of credit for small businesses in the short term with no attendant decline in loan quality.[116] The binary view of lending as either transaction or relationship has also been critiqued, as the blanket term "transaction lending" is actually comprised of numerous different lending technologies, the majority of which are used for both informationally opaque and transparent firms alike. In actual fact, large lenders use "hard" information (e.g. credit score, asset valuations, quality of accounts receivable) in order to combat the opacity issues of SMEs.[117]

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[116] Berger, Cowan, and Frame, "The Surprising Use of Credit Scoring in Small Business Lending by Community Banks and the Attendant Effects on Credit Availability, Risk, and Profitability," 16.
[117] Udell and Berger, "A More Complete Conceptual Framework For Financing Of Small And Medium Enterprises," 1.

CHAPTER 3: RESEARCH QUESTIONS & METHODOLOGY

The previous chapter set the stage for the research undertaken in this thesis, by describing the unmet debt financing needs of Toronto SMEs and delving into the concepts of values-based banking and relationship lending. This chapter will outline the research question and hypothesis proposed at the start of this project, and detail the methodological approach and data collection plan used in the research process.

3.1: Research Questions

This study focuses on the values-based finance market in Toronto, with the aim of determining the process by which values-based lenders perceive and quantify credit risk for loans to SMEs. The goal is to give readers a better understanding of whether, and how, values-based banks can meet the needs of SME customers who are currently unserved or underserved by the traditional credit market. The idea is that this may help improve the accessibility and cost of financing for SMEs in Toronto. In order to ask this broader question, I chose to break the research area into several sub-questions:

1) Who are the values-based institutions lending to SMEs in Toronto, and how do they articulate their goal or purpose?
2) Is there a market for values-based lending in Toronto? Are there commercial clients who are unserved or underserved by traditional banks, or for whom high interest rates form too much of a burden?
3) What processes or factors do values-based lenders use to quantify risk for business loans? How do they believe this process differs from traditional lenders?
4) What is the role of customer and community relationships in the lending process for values-based lenders?
5) What has been the connection, if any, between values-based lending and default rates or loan losses in practice?

Based on a review of existing literature, and informal discussions with individuals working in the field of values-based banking, my initial hypothesis was that values-based lenders would inherently prioritize relationships with clients and communities, because they have a stated social purpose (either related to the business, or the business owner). As values-based lenders have more established ties and community knowledge, as well as lesser organization-level profit pressures than traditional lenders, they may attribute lower credit risk to local SMEs and therefore be able to provide credit on more favourable terms than traditional banks.

3.2: Methodological Approach

The methodical approach employed in this thesis is a case study of the values-based SME debt finance market in Toronto. Toronto is a natural focus for an analysis of the gap between SME debt financing needs and the products/services provided by the traditional banking sector, given its status as the head office location of all of the Big Five Canadian domestic banks. In addition, Toronto is the Canadian CMA with the fourth highest proportion of debt financing provided by a domestic chartered bank (preceded by St. John's, Newfoundland; Calgary, Alberta; and Kitchener-Cambridge-Waterloo, Ontario).[118]

Specifically, the case study analysis was informed by a series of semi-structured interviews with values-based or socially-oriented lenders in Toronto. In determining eligibility for the study, I focused on institutions that had a social goal in addition to financial performance. This social goal needed to be either explicitly stated in the mission statement of the organization (e.g. targeted at young entrepreneurs or businesses addressing social issues) or implicit in their business model (e.g. credit unions, peer-to-peer lending). The content of these interviews was driven by a pre-determined set of four questions. These questions were crafted to cover corporate values, as well as both organization-level and individual loan-specific policies, practices, terms of credit and loan performance regarding loan origination to SMEs.

[118] Statistics Canada and Innovation, Science and Economic Development Canada, "Survey on Financing and Growth of Small and Medium Enterprises, 2017," fig. 2.

The guiding questions were as follows:

1) It is my understanding that your organization has a values-based or social goal, beyond financial performance. How would you articulate this goal? Are there certain characteristics/features/qualities of your organization that make you a "values-based" lender?
2) Describe the importance of SME lending to your business, and what you as a values-based organization are able to offer SME clients.
3) Describe your institutional process for credit risk assessment and loan origination for lending to SMEs.
4) How do you think about the role of relationships with customers and community, based on your strategic vision of values-based banking?

These questions were designed to allow for open-ended responses in the words of interviewees, however each included a series of cues/follow-up questions to ensure that a standard baseline of information was discussed with all interviewees (refer to Appendix A for the full list of follow-up questions).

3.3: Data Collection

An initial assessment of the SME lending market in Toronto yielded a spectrum of financial institutions, ranging from traditional domestic banks to online peer-to-peer lending platforms. This broad list was refined to a smaller subset of potential interview subjects, consisting of those institutions with a social mission beyond financial performance. This categorization was based largely on internet research (corporate websites), as well as initial discussions with a Toronto values-based lender. The preliminary list consisted of 16 institutions, broadly categorized as social lenders, credit unions, peer-to-peer lending platforms, microfinance lenders, and government institutions and programs.

All potential interview subjects were initially contacted via email, or through dedicated "contact us" sections of organizational webpages where a contact email address was unavailable. The initial contact email provided background information about the project, and requested a 45 minute interview. When possible, interview subjects were responsible for loan origination or risk management functions at their

respective institutions. Follow up emails and phone calls were conducted to maximize the response rate. In one case, I reached out to multiple employees of a single institution to get a more diverse perspective.

Of the 16 organizations that were initially identified, I successfully conducted interviews with employees of 10. Two declined to participate in the study, due to a lack of resources or changing lending practices. Four failed to respond to the interview request, even after multiple follow-ups. Each of these organizations was contacted between four and six times via email, phone, or handwritten note, depending on responsiveness, and while some replied indicating they were attempting to address the interview request, no interviews were scheduled. The preliminary list of 16 was augmented with interviews with employees from an additional three lenders, based on feedback from other interviewees.

A total of 14 formal interviews were ultimately conducted from January through March 2019. Several interviews were conducted in person in Toronto during the last week of January, however the remainder were conducted via skype or phone call due to scheduling constraints and the need to follow up with potential respondents over a longer than expected period of time. In-person interviews were conducted in coffee shops, other public locations (e.g. lobby of a building) or in corporate offices. Several respondents requested a copy of the questions in advance for phone or skype interviews, and in these cases, the four guiding questions were provided via email prior to the interviews. In order to analyze the largely qualitative data, those interviews that were recorded were transcribed, and those where notes were taken by hand were typed up. Transcripts of the interview recordings, or typed notes in the cases of interviews that were not recorded, were coded according to major themes and sub-themes. A number of the interviewees wished to remain anonymous, and as such comments from these individuals included in the following analysis do not include interviewee names, titles, or institution names.

The values-based lenders that were contacted for this study are in no way an exhaustive list of such institutions in Toronto, and merely represent those that were most readily identifiable. Even of those identified and contacted, the perspectives of the institutions that did not respond to the interview requests leave a gap in the findings, and may limit general applicability. Notably, the study did not include any lenders who conduct their operations solely online. Given that a portion of the research focused on the

importance of relationships on the lending process, interviews with these online platforms may have yielded important and potentially contrary findings. In addition, this study did not include interviews with traditional financial institutions. With additional time and resources, further studies could include discussions with traditional lenders to confirm the existence of the market gaps identified by values-based lenders, as well as provide additional insight into their credit processes. This would help to highlight the differences, or similarities, between the credit assessment processes of values-based versus traditional lenders.

CHAPTER 4: WHAT IT MEANS TO BE A VALUES-BASED LENDER

The previous chapter outlined the research questions being investigated, and the methodologies and data collection tools used to do so. In this chapter, I will use the research findings to establish six types of values-based lenders currently serving the Toronto SME market, and detail what aspects of their operations these lenders feel make them "values-based". Based on interview data, these values-based lenders exist to fill gaps left in the private SME debt market by traditional banks. This chapter will compile a list of such market gaps, and discuss the key role that risk perception plays in the difficulties SMEs, charities, co-operatives, non-profits and vulnerable populations face in trying to access credit.

4.1: The Spectrum of Values-Based SME Lending in Toronto

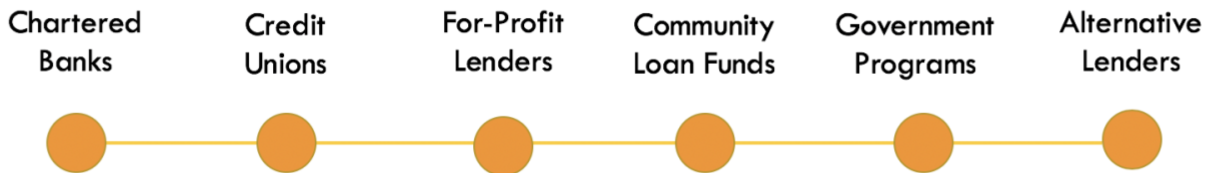
As discussed in Chapter 3, I focused on lenders with a social purpose, that was either explicitly stated, or implicit in the business model. In an attempt to map out of the sphere of values-based lenders in Toronto, organizations were categorized across a number of factors based on interview responses and/or publicly available information (refer to Figure 4). While not all organizations provided information that mapped perfectly to categories, the general themes were sufficient to group lenders for purposes of this analysis.

Figure 4: Factors Used to Classify Values-Based Lenders

CLIENT FACTORS
▪ Type of client served (e.g. for-profit, non-profit, charities, social enterprise) ▪ Business stage of client (e.g. start-up, small, medium) ▪ Geography served (e.g. Toronto, Ontario, Canada) ▪ Industries served
ORGANIZATIONAL FACTORS
▪ Share of business focused on SME lending ▪ Mission or goal ▪ Corporate structure (e.g. credit union, bank, fund manager, foundation) ▪ Profit structure (i.e. for-profit or non-profit) ▪ Number of employees ▪ Number of organizational touchpoints for each client relationship ▪ Source of funding (e.g. deposits, government, foundations, corporations) ▪ Ownership (e.g. external shareholders, members, government) ▪ Minimum profitability threshold for lending decisions (if any)
CREDIT FACTORS
▪ Services provided (i.e. funds, time, additional resources) ▪ Interest rate charged ▪ Flexibility of financing package ▪ Average loan size ▪ Average length of loan term ▪ Type of financing provided (e.g. operating loan, term loan, line of credit, credit card) ▪ Key determinants of credit risk ▪ Ultimate decision maker regarding loans ▪ Customer involvement in credit adjudication process (if any) ▪ Default rate on loans
MACRO FACTORS
▪ Market gap being addressed ▪ Regulating entity ▪ Connections to other values-based institutions (lenders, or otherwise)

Based on these factors, the values-based lenders identified can be loosely grouped into six categories: i) chartered banks; ii) credit unions; iii) for-profit lenders; iv) community loan funds; v) government institutions and programs; and vi) alternative lenders.

Figure 5: Spectrum of Values-Based Lenders Serving Toronto SMEs



i. Chartered Banks

- **Goal:** Market rate financial return + some social/environmental impact
- **Client Base:** All industries, focus on larger loan sizes
- **Organizational Structure:** For-profit
- **Ownership:** Shareholders
- **Source of Funds:** Depositors
- **Interest Rate Charged:** Market rates
- **Debt Instrument:** Loans & Credit Cards

As discussed above, Canada's banking market is dominated by the Big Five banks, which are all large and publicly-traded institutions. As they aim to maximize value for their shareholders they are generally profit driven, however there are examples of programs where these large banks have partnered with other organizations to create values-based lending programs. One example of this is the Ontario Catapult Microloan Fund at Toronto's Centre for Social Innovation ("CSI"), a program that provides loans of $5,000 to $25,000 to social enterprises. The program is a partnership between CSI, the Ontario government, Alterna Savings credit union, Microsoft Canada, Toronto-Dominion Bank, KPMG and Social Capital Partners.[119]

[119] Centre for Social Innovation, "The Ontario Catapult Microloan Fund."

While most Canadian chartered banks follow a more traditional, profit maximizing approach with regard to their core operations, there is at least one values-based exception. Vancity Community Investment Bank ("VCIB"), a Toronto-based wholly-owned subsidiary of Vancouver City Savings Credit Union (commonly known as "Vancity"), was known in a previous life as Citizen's Bank, an institution that was founded in 1997.[120] According to their website, VCIB is "focused 100% on community and environmental impact" by providing loans and investment banking/advisory services.[121] It is unique in the sense that it is ultimately owned by credit union members of Vancity, as opposed to potentially unrelated shareholders of a traditional bank.

ii. Credit Unions

- **Goal:** Market rate financial return + some social impact
- **Client Base:** All industries, tend to be smaller loans
- **Organizational Structure:** Non-profit
- **Ownership:** Members
- **Source of Funds:** Members
- **Interest Rate Charged:** Market rates
- **Debt Instrument:** Loans & Credit Cards

According to the Canadian Credit Union Association, credit unions differ from banks in that they are financial co-operatives, meaning they are actually owned by their customers. Credit unions members have a say in how the co-operatives are run, and Boards of Directors are locally elected so that they are able to accurately represent the needs of members and the community.[122] Profits generated by credit unions are paid out to their members as dividends, or donated back to community initiatives.[123]

The credit union model has a strong history in Canada, with the first credit union in North America, Caisse populaire des Lévis, being founded in 1901.[124] Many credit unions were initially created to serve

[120] Vancity Community Investment Bank, "On a Mission."
[121] Vancity Community Investment Bank.
[122] Canadian Credit Union Association, "The Credit Union Difference."
[123] Canadian Credit Union Association.
[124] Karim Harji et al., "State of the Nation: Impact Investing in Canada," 13.

communities that had restricted access to capital from traditional sources, but have in fact proven over time that these communities were bankable.[125] These institutions have been leaders of financial innovation and inclusion over the years, with credit unions being the first to offer many solutions, including being first to provide loans to women (1961), introducing the first debit cards (1982), and providing the first alternative loans to payday lenders (2014).[126]

There are now 252 credit unions/caisse populaires operating across the country, providing financial services to 5.72 million Canadians, and these entities are the sole financial institutions in 395 communities.[127] Canadian credit unions gave an average of 5.4% of pre-tax income to community donations/sponsorship, a significantly higher percentage than the Big Five banks (<1%).[128] In 2016, credit unions and caisse populaires collectively provided 18.5% of total small business lending in Canada, which was on par with the Royal Bank of Canada, the largest of the Big Five in terms of small business lending market share, and well above the 8.1% provided by "other" institutions. [129]

As the market overlap between credit unions and banks has increased over time, there has been a wave of consolidations in the credit union industry. In reality, this means that many credit unions have become, in the words of one interviewee "banks that happen to be member owned".[130] While credit unions provide many of the same services as banks, some also consider additional social factors, and often lend to borrowers who would have difficulty getting financing on good terms from traditional lenders (e.g. non-profit organizations).[131]

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[125] Identity Confidential, Interview by author, January 31, 2019.
[126] Canadian Credit Union Association, "2018 Credit Union Community & Economic Impact Report," 11.
[127] Canadian Credit Union Association, 3.
[128] Canadian Credit Union Association, 5.
[129] Canadian Credit Union Association, 7.
[130] Identity Confidential, Interview by author, January 31, 2019.
[131] Karim Harji et al., "State of the Nation: Impact Investing in Canada," 25.

iii. For-Profit Lenders

- **Goal:** Market returns + social impact
- **Client Base:** Varies
- **Organizational Structure:** For-profit
- **Ownership:** Private
- **Source of Funds:** Investment from individuals, foundations, other institutions etc.
- **Interest Rate Charged:** Varies
- **Debt Instrument:** Loans

For-profit values-based lenders are financial institutions who have articulated a social mission, however are still concerned with making a reasonable return for investors. The for-profit lenders varied considerably in terms of lending approach and services offered, albeit the sample size was limited. For example, New Market Funds is a for-profit investment firm, but is owned by a registered charity, and aims to generate market-based financial returns while also achieving some social or environmental impact.[132] The Community Forward Fund, one of New Market Funds' loan funds, is intended to fill the charitable sector's need for patient capital,[133] and investors are foundations (community and private) and other institutions.[134] Another lender, Lending Loop, which is an online peer-to-peer lending platform, aims to support the growth of small businesses by making loans to the segment that is currently underserved by traditional lenders.[135] The entire loan application process is online, and the interest rate charged depends on the credit rating determined by Lending Loop, but ranges from 5.90% for the most credit-worthy clients to 26.50% for the least credit-worthy.[136] As a peer-to-peer platform, Lending Loop appears to be geared toward individual retail investors.

[132] Tides Canada, "New Market Funds Launches Canada's First Market-Based Affordable Housing Investment Fund."
[133] Community Forward Fund, "Overview."
[134] Community Forward Fund, "Selected Investors."
[135] Lending Loop, "Our Story."
[136] Lending Loop, "Rates and Fees for Borrowers."

iv. Community Loan Funds

- **Goal:** Primarily social impact
- **Client Base:** Some serve specific populations, tend to be smaller loans for earlier stage businesses (<$50,000)
- **Organizational Structure:** Non-profits, co-operatives, charities, foundations
- **Ownership:** Private
- **Source of Funds:** Donations or investment from individuals, corporations, foundations, government etc.
- **Interest Rate Charged:** Below market rates
- **Debt Instrument:** Loans + Loan Guarantees

One interviewee, employed at credit union that has partnerships with several community loan funds, described these entities as non-profit organizations that want to provide financing to underserved or underrepresented individuals.[137] Some may have mandates to serve a specific group of people (e.g. Rise Asset Development caters to clients with mental health or addiction challenges[138]), while others have a broader mandate.

The MaRS Centre for Impact Investing & Purpose Capital identified at least 14 community loan funds providing debt financing in Canada, two of which were operating nationally and four of which were operating exclusively in Ontario. The majority of these community loan funds are in urban cores and serve local markets.[139] While MaRS and Purpose Capital identified foundations as a separate source of impact financing, for purposes of this analysis, foundations have been grouped together with community loan funds.

The bulk of the values-based lenders interviewed as part of this project fell into the category of community loan funds. For purposes of this analysis, this category includes both organizations that provide funding, as well as those that provide some other support in order for SMEs to access funding. For example, ACCESS Community Capital Fund, a Toronto-based charity, uses funds from investors to guarantee small

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[137] Identity Confidential, Interview by author, February 28, 2019.
[138] Dea, Interview by author.
[139] Karim Harji et al., "State of the Nation: Impact Investing in Canada," 24.

business loans made through other credit unions or banks.[140] While the dollars invested are not directly lent to small businesses, guarantees against these funds allow borrowers to access loans from traditional lenders at reasonable interest rates.

v. Government Institutions & Programs

- **Goal:** Social impact
- **Client Base:** Varies, tend to serve early stage businesses
- **Organizational Structure:** Government
- **Ownership:** Government
- **Source of Funds:** Taxpayers
- **Interest Rate Charged:** Varies
- **Debt Instrument:** Loans + Loan Guarantees

As discussed earlier, provincial, federal and municipal governments provide a wide range of support for small businesses, however there are few programs that actually commit government funds to lending. One government institution that does do this is the Business Development Bank of Canada ("BDC").

According to their website, BDC is "the only financial institution devoted exclusively to entrepreneurs", serving 56,000 across Canada with a focus on small and medium-sized businesses.[141] BDC is wholly owned by the Government of Canada, but is operated at arm's length and has a financially sustainable business model.[142] BDC is itself a certified "B Corp", or a beneficial corporation, meaning it is committed to creating social and not just monetary value.[143] BDC has a higher risk tolerance than traditional banks (BDC's lowest risk clients would still likely be risker than the highest risk client at a traditional bank).[144]

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[140] ElSayeh, Interview by author.
[141] Business Development Bank of Canada, "Who We Are."
[142] Business Development Bank of Canada.
[143] Business Development Bank of Canada, "We're a B Corp."
[144] Ryan, Interview by author.

vi. Alternative Lenders

- **Goal:** Primarily social impact
- **Client Base:** Varies
- **Organizational Structure:** Varies
- **Ownership:** Private
- **Source of Funds:** Varies
- **Interest Rate Charged:** Varies
- **Debt Instrument:** Alternative forms of debt to traditional bank products (e.g. community bonds)

While the vast majority of values-based organizations providing debt financing to SMEs in Toronto are doing so through traditional means, namely operating loans, term loans, or lines of credit, there are some that fall outside of this box. One such debt instrument is the community bond. Community bonds are similar to corporate or government bonds in that they have a set face value, term, and interest rate; however, they differ in that that must generate a social or environment benefit, and they are issued by charities, non-profits or co-operatives.[145]

In the Canadian market, Tapestry Community Capital is an organization that will help potential issuers structure their bonds, facilitate the fundraising process and provide investor management and administrative functions post-issuance.[146] In this case, funding is coming from community members, so the assets financed via the bonds ultimately become community owned. Tapestry supports non-profit and co-operative issuers to engage their supporters as investors.[147]

4.2: What do Values-Based Lenders Look Like?

The analysis up to this point has focused on grouping lenders, according to factors like their organizational structure, source of funds and the interest rates they charge to their borrowers, in order to form a model of the organizations currently serving the SME lending space in Toronto. This analysis focused on what differentiated lenders, not what made them similar. What has yet to be discussed are these

[145] Tapestry Community Capital, “What Is a Community Bond?”
[146] Tapestry Community Capital, “Tapestry Services for Every Stage of Your Bond Raise.”
[147] Collins-Swartz, Interview by author.

lenders' views on what features or characteristics make their organizations "values-based". These are the idea and concepts that unify them. These lenders were initially identified because I felt they had a social purpose beyond financial returns, whether this was explicitly stated or implicit in their business models. During the interview process, interviewees were asked to offer their perspectives in their own words.

Over the course of the interviews, there were several themes that emerged regarding what made these lenders "values-based" organizations. These major themes were: i) purpose of the organization; ii) the concept of character-based lending; iii) social and/or environmental impact of loans; iv) provision of non-financial services; v) concern for client well-being; vi) values-aligned procurement; and vii) marketing appeal.

i. Purpose

All organizations interviewed had some sort of social purpose, whether it was explicitly stated in their mission statement or implicit in their business model. This concept of purpose was further explored during the interview process. Craig Ryan, Director of Social Entrepreneurship at BDC, made a very interesting point about values, noting that people very often talk about them in the abstract and it is difficult to articulate what they actually mean in practice. Instead of the values or mission, he felt that purpose is the word that changes things. The inclusion of purpose in legal incorporation documents can signal a true commitment to generating social value.[148] He also relayed a useful analogy originally made by the CEO of Whole Foods, in which he compared the relationship between red blood cells and the purpose of life to the relationship between profit and purpose of business.[149] One is necessary to achieve the other, but pursuit of profit alone is not the sole purpose of a business.

This became abundantly clear in speaking with values-based lenders. When asked to articulate their goals, none of the respondents mentioned profit. Instead, they made statements that indicated a much higher social purpose. Christina Baker, Director of Community Lending at New Market Funds, described the

[148] Ryan, Interview by author.
[149] Ryan.

organization as focused on ensuring that people have access to homes.[150] Beth Dea, Chief Operating Officer at Rise Asset Development, shared her organization's "Theory of Change", where the ultimate long-term desired outcome is "increased quality of life for people with mental health and addiction challenges."[151] Beth Coates, Financial Manager at the Canadian Alternative Investment Foundation and Cooperative ("CAIF" and "CAIC"), noted the organization's focus on social justice and access to capital for underserved groups, calling it "capital for elevation as opposed to oppression."[152] Ryan Collins-Swartz, Social Impact Manager at Tapestry Community Capital, indicated that Tapestry's ultimate goal was to support Canadian non-profits to finance their dream projects with community investment.[153]

For some organizations, the goals were less social and more economically driven. For Craig Ryan, the purpose of his group at BDC was about supporting social entrepreneurs. An employee at one government program said the organization's work was about stimulating the economy.[154] Lindsay Morris, Executive Assistant to the CEO at Windmill Microlending, articulated the organization's overall goal as helping internationally-trained professionals relicense to be able to work in Canada.[155] An employee of one credit union described the purpose of the community finance program as supporting job creation and entrepreneurship.[156]

ii. Character-Based Lending

A term that came up in several interviews, in the context of questions about values-based lending, was "character-based" lending. According to Lindsay Morris, Windmill considers themselves a character-based lender, meaning that while they do look at traditional financial metrics when making loans (e.g. credit reports, financial analysis), they largely make lending decisions based on character. As part of this process, they conduct interviews with applicants, and obtain character references for potential borrowers.[157] Along

[150] Baker, Interview by author.
[151] Rise Asset Development, "Rise Results Chain."
[152] Coates, Interview by author.
[153] Collins-Swartz, Interview by author.
[154] Identity Confidential, Interview by author, February 20, 2019.
[155] Morris, Interview by author.
[156] Identity Confidential, Interview by author, February 28, 2019.
[157] Morris, Interview by author.

the same vein, Beth Coates said that when the Canadian Alternative Investment Cooperative was making loans to social enterprises, many were so outside of the box they couldn't rely on the traditional loan assessment tools. While they still did the usual financial analysis, they acknowledged that they were serving higher risk businesses, and lending ended up being more character-based.[158] For CAIC, this involved looking at things like the resilience, experience, resources and support structure (e.g. community) of a potential borrower.[159] Mona ElSayeh, Executive Director at ACCESS Community Capital Fund, said that the organization's loan review committee also uses a character-based lending approach. While they still look at an applicant's credit score and existing debt load to ensure they are not placing an undue burden on the client, they also look at character-based factors like integrity, honesty, reliability, and back-up supports.[160]

The term also came up in the context of microlending. An interviewee working at one credit union echoed these ideas, saying that in the absence of traditional credit assessment tools for small businesses (e.g. past financial performance, client base, repayment history), microlenders rely on character-based lending criteria, such as the skills of the applicant.[161]

iii. Social and/or Environmental Impact

Many of the lenders also considered the social or environmental impact of their loans when making lending decisions. At one community development lender, all new loans need to have some positive social or environmental impact, and they have gone so far as to have an external auditor come in to compare these against the firm's set of impact guidelines.[162] For CAIC, when the firm's advisory board was making lending decisions they would rate each loan out of ten across a number of social metrics, looking at things like marginalization, potential for empowerment, geographic isolation and environmental impact.[163] At

[158] Coates, Interview by author.
[159] Coates.
[160] ElSayeh, Interview by author.
[161] Identity Confidential, Interview by author, February 28, 2019.
[162] Identity Confidential, Interview by author, January 31, 2019.
[163] Coates, Interview by author.

another credit union, they assess loan impact across three scales: the micro scale (i.e. how the loan impacts the productivity and self-sufficiency of the individual receiving the loan); the meso scale (i.e. how the loan affects the organization in terms of its goals of poverty alleviation and brand differentiation within the community); and the macro scale (i.e. how the loan impacts the local economy more broadly, in terms of metrics like job creation and financial inclusion of vulnerable groups).

For other organizations, impact measurement was not part of the lending process; however, the loans that they make can still have a positive social or environmental impact. For BDC, there is no mention of values in the organization's mission statement. As Craig Ryan said, the role of BDC is not to create social or environmental impact, and all entrepreneurs are treated in the same way regardless of their mission statement.[164] According to Ryan, the biggest impact that BDC's Social Entrepreneurship division can have is to spread the b-corp movement.[165]

iv. Provision of Non-Financial Services

Based on interviews, many values-based lenders provided non-financial supports in addition to financing. For example, Rise Asset Development has a mandatory mentoring program linked to all loan disbursements, to provide borrowers with a contact person to ask questions of and discuss ideas.[166] Another credit union provides clients with what they term "wraparound supports", which include things like financial literacy and education programs, ongoing check-ins with borrowers, and connections to other organizations for support with things like mentoring and employment assistance.[167] At one community development lender, account managers invest time in helping their clients beyond just finances (e.g. an account manager sending relevant grant applications to borrowers who might want to apply).[168]

Providing more fulsome support services to clients also helps them to build their financial capacity, increasing their financial independence and helping them transition to accessing credit through more

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[164] Ryan, Interview by author.
[165] Ryan.
[166] Dea, Interview by author.
[167] Identity Confidential, Interview by author, February 28, 2019.
[168] Identity Confidential, Interview by author, January 31, 2019.

traditional channels in the longer term. The specific term "financial capacity" came up in the context of community bond issuances. Ryan Collins-Swartz, Social Impact Manager at Tapestry Community Capital, noted "through a lot of our work, we recognize the importance to increase the financial capacity of non-profits, co-ops and charities, and the social sector at large, and I think it's really important that we're acting as the group that's increasing the financial capacity of groups, to go out and raise investments on their own." Collins-Swartz said that while traditional lenders may expect clients to come in with a fully fleshed-out business plan, Tapestry actually works with clients to develop their capacity through the bond issuance process.[169] As many of the other values-based lenders interviewed provided coaching and mentoring programs in addition to funding, I would argue that these programs also serve to build the financial capacity of borrowers, making them more financially independent along the way.

v. Concern for Client Well-being

Several respondents noted that their organizations would not make a loan if taking on debt was not in the best interest of the client. They felt a responsibility to their customer, not to burden them with debt if it was going to hurt them. Instead of just considering the risk for the bank when assessing loans, these organizations also considered the risk of that debt for the client. Lily Steponaitis, previously a post-graduate fellow at MIT's CoLab, expressed the importance of sustainability, not just for the institution granting a loan, but also for the borrower. If making a loan to a company is not going to help them generate future income, then debt may not be the best solution.[170] Another interviewee, employed by a credit union, indicated that as a financial institution in a powerful and privileged position, they have a responsibility to be critical of how they interact with vulnerable populations.[171] For ACCESS Community Capital, one of the pillars of lending is to do no harm to the client, and so they look at a potential borrower's existing debt load when making loan decisions.[172]

[169] Collins-Swartz, Interview by author.
[170] Steponaitis, Interview by author.
[171] Identity Confidential, Interview by author, February 28, 2019.
[172] ElSayeh, Interview by author.

vi. Values-Aligned Procurement

In several conversations, interviewees mentioned that for them, being "values-based" extended beyond just their lending operations, and included how they themselves operated as a business. Specifically, procurement of goods and services through values-aligned organizations seemed to be a common theme.

As an example, New Market Funds is very mindful about what they are buying, and who they are buying it from, even though it may be costlier for the organization. Christina Baker, Director of Community Lending at New Market Funds, noted the example of an order for company clothing. The organization made sure to purchase from an ethically-minded supplier, and had the printing work done at a company where the employees were paid a fair wage.[173] Another employee at a community development lender noted that their firm is thinking more about procurement from social enterprises and values-aligned suppliers, when ordering everything from catering to office supplies.[174]

vii. Marketing Appeal

Many interviewees noted that being "values-based" institutions was actually appealing to clients, in some cases serving as a differentiating factor if clients were choosing between multiple financial institutions. An employee at one credit union said the fact that they are able to invest more in the local community, and that discretion for such investments resided with the branch manager as opposed to higher level corporate executives, has been a deciding factor for some clients.[175] For the Canadian Alternative Investment Corporation, their clients liked that the organization had a social justice purpose.[176] In the community bond space, Ryan Collins-Swartz said that there are groups who could get financing elsewhere, but like the idea that their projects could be community financed, and that it may even be good for business in the long-run.[177]

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[173] Baker, Interview by author.
[174] Identity Confidential, Interview by author, January 31, 2019.
[175] Identity Confidential, Interview by author, January 30, 2019.
[176] Coates, Interview by author.
[177] Collins-Swartz, Interview by author.

4.3: Market Gaps

Based on the above discussion, it is clear there is a wide range of values-based lenders serving the Toronto SME market. While the interviewees varied significantly in terms of clientele, product offering and corporate structure, they all identified a clear market gap that they were created to fill. While some, like credit unions, were initially created to serve populations and geographies that are now largely served by traditional banks,[178] others are serving clients who are still unable to borrow elsewhere. In many cases, the capital provided by these lenders is necessary to get a business off the ground, or a project done. Based on interview responses, I identified five major market gaps. These included: i) access to credit for small business; ii) access to credit for charities, co-operatives and non-profits; iii) financial services for vulnerable populations; iv) flexible & long-term financing solutions; and v) lack of clear funding progression. While this research primarily looks at lending to SMEs, the focus on values-based lenders meant that the clientele often expanded to include these other groups.

i. Access to Credit for Small Business

According to one interviewee, providing capital to start-ups and entrepreneurs is considered "sexy", and so benefits from a lot of attention and resources. However, these values-based initiatives end up being "pockets of activity" for organizations that otherwise fall short of embedding social or environmental values in their operations.[179] While a certain segment of start-ups benefit from these initiatives, the rest of the SME market faces challenges when trying to access credit from traditional lenders.

Banks generally prefer to make larger loans, as they can earn the equivalent amount of interest income from a few large loans as from many small loans. [180] For small loans, the upfront transaction costs are high, and it can sometimes take years for the lending relationship to be profitable.[181] In addition, many

[178] Identity Confidential, Interview by author, January 31, 2019.
[179] Identity Confidential.
[180] Identity Confidential, Interview by author, February 28, 2019.
[181] Identity Confidential.

small businesses in Canada find it difficult to get short-term operating funding.[182] Craig Ryan, Director of Social Entrepreneurship at BDC, indicated that while most small businesses need term loans and working capital, people don't find this as interesting to talk about as venture capital and entrepreneurship.[183]

Different from some developing economies, in countries with developed financial markets, businesses have access to credit cards. For a bank, it is cheaper and more profitable to issue a business with a credit card for a given amount of credit that it would be to issue a loan for a same amount, but by the same token this is more expensive for the customer and may preclude them from successfully starting a business.[184]

While small businesses may find it difficult to obtain credit from traditional lenders, the values-based lending market is clearly working to address this issue. The values-based organizations interviewed, with some exceptions, primarily served small and medium-sized businesses. In some cases, this was linked to their purpose or mandate. In other cases, it seemed to be a capacity issue; many of the interviewed organizations had a small employee base (2-50 people). Lily Steponaitis felt that many values-based lenders focus on the SME market because this is the market they are best able to serve given their capacity, resources and skills, and that lending to larger organizations is usually done in conjunction with other financial institutions.[185] However, she also noted that another reason values-based lenders target the SME market is because it is easier for a small business to be values-aligned, as they tend to have fewer stakeholders and less complicated supply chains.[186] Regardless of the reasoning, a focus on SME lending has allowed these values-based lenders to devote significant resources to this segment.

Jane Bisbee, Executive Director of the Alberta-based Social Enterprise Fund, was able to offer an interesting and external perspective of the Toronto SME finance market. From Bisbee's perspective, many

[182] Identity Confidential, Interview by author, February 20, 2019.
[183] Ryan, Interview by author.
[184] Identity Confidential, Interview by author, February 28, 2019.
[185] Steponaitis, Interview by author.
[186] Steponaitis.

organizations in Toronto are overcomplicating the function of getting money from a lender to a borrower.[187] While groups are excited about new and innovative products like community bonds, much of the benefit ends up being lost to lawyers and executives at the expense of the community.[188]

ii. Access to Credit for Charitable Sector, Co-operatives & Non-Profits

According to Beth Coates, Financial Manager at the Canadian Alternative Investment Foundation and Cooperative, while there is lots of talk among private industry and government about direct investment in the charitable sector, "very few are actually rolling up their sleeves, and, and getting their hands dirty, and taking the risks that we […] have taken."[189] In fact, CAIC itself was started in response to a clear need for loan capital in the charitable sector. In the words of Coates, "people would show up at the front door of the convent, saying, you know, listen, we just want to borrow this money, we want to start a food bank, we want to buy that house down there", and instead of having to send them away, CAIC was a way to institutionalize a response.[190] Similarly, Christina Baker, Director of Community Lending at New Market Funds indicated that there is a parallel financing gap for co-operatives, and the institution operates a fund specifically to serve this market.[191]

Lack of access to credit extends to non-profits as well. While for-profit businesses can get easily credit cards, the same is not true for non-profits. The process for a non-profit to get a corporate card from a bank is long and tedious, and can involve posting cash security or getting the line guaranteed by their Board of Directors.[192] Along the same lines, for-profit small business can often get government support through BDC, however there is no comparable funding provider for non-profits.[193]

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[187] Bisbee, Interview by author.
[188] Bisbee.
[189] Coates, Interview by author.
[190] Coates.
[191] Baker, Interview by author.
[192] Identity Confidential, Interview by author, January 31, 2019.
[193] Identity Confidential.

iii. Providing Financial Services to Vulnerable Populations

Mainstream institutions are struggling to meet the financial needs of vulnerable populations. Several interviewees worked for organizations that were focused on serving specific vulnerable or underserved segments of the population in Toronto.

- **Newcomers:** Windmill Microlending provides loans to recent immigrants and refugees to recertify in their field in Canada, which they would otherwise not be able to access, either at all or a at a reasonable interest rate, from traditional lenders.[194] While not specifically providing loans to SMEs, Windmill's loans have a clear and direct impact on employment and economic opportunity for borrowers and their families.
- **Women:** One credit union has a dedicated loan program for female entrepreneurs, providing up to $25,000 for businesses with one-year of operating history and a minimum credit score.[195] Women still face challenges getting financing (e.g. men still receive more venture capital funding) and have been the primary users of the microcredit program at this organization. The program serves women who, even those with strong post-secondary education, are still being undervalued and want to be more self-sufficient.[196]
- **Mental Health & Addiction:** Rise Asset Development, which serves clients with mental health or addiction challenges, is one of only two organizations across the country providing this service, and Rise COO Beth Dea expressed the feeling that there is an unmet need.[197]

Working to fill the needs of vulnerable populations has also led to innovation. One credit union takes the approach of looking for gaps in the financial market and trying to fill them, which has ultimately led to the development of new products to help underrepresented groups.[198] For example, the process of making

[194] Morris, Interview by author.
[195] Identity Confidential, Interview by author, February 20, 2019.
[196] Identity Confidential, Interview by author, February 28, 2019.
[197] Dea, Interview by author.
[198] Identity Confidential, Interview by author, February 28, 2019.

a loan to a newcomer has allowed the credit union to develop stronger overall financial solutions for that customer segment.[199]

iv. Flexible & Long-Term Financing Solutions

Often, values-based lenders seemed to be able to offer better terms than a traditional bank. In some cases, this meant below market interest rates, while for others it meant more flexible credit terms or innovative loan products (e.g. bridge financing). For example, Windmill Microlending tends to be able to offer better terms and lower interest rates to newcomers than they could access through a traditional lender.[200] An employee at one community development lender described the organization's flexible approach as "more solutions oriented", and something that doesn't exist everywhere in the Canadian market.[201] Christina Baker, Director of Community Lending at New Market Funds, provided the example of providing a client with a short-term bridge loan, to meet their funding needs while they were waiting to receive grant funding from a government or foundation.[202]

Time horizon was also an important point here, in that there is a lack of patient capital in the market. For example, BDC has moved away from impact investing, as even those investors who were concerned with social or environmental impact still had relatively narrow and short-term perspective in that they were concerned about financial returns.[203] Jane Bisbee, Executive Director of the Alberta-based Social Enterprise Fund, gave the example of a non-profit customer working with a traditional bank who ran into some financial difficulty. Instead of trying to help the client improve the profitability of their business model (e.g. growing revenue streams, reducing expenses), the approach that would have been in the best interest of the client, the bank focused on short-term and one-time sources of capital (e.g. grant funding, sale of property) that would get the lender repaid.[204]

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[199] Identity Confidential.
[200] Morris, Interview by author.
[201] Identity Confidential, Interview by author, January 31, 2019.
[202] Baker, Interview by author.
[203] Ryan, Interview by author.
[204] Bisbee, Interview by author.

There was also an emphasis on treating your customer as human-being, rather than as a number. At Windmill Microlending, they believe in their clients and their respective goals for the future, and consequently choose to invest time and money in helping them support these goals.[205] In the words of Beth Dea, COO at Rise Asset Development, "we often hear that Rise is the only place that sort of had faith in me when, you know, when you're seeing all kinds of professionals for whatever challenges you might have whether that's social service or mental health, you know, there's so many people in authority, and it's nice to have somebody just treat them like an entrepreneur for a change."[206]

v. Lack of Clear Funding Progression

Interviewees also identified a gap in terms of available financing for SMEs as they grow. One interviewee noted that in the Canadian market, there is a gulf between SME lenders and the Big Five domestic banks, making it difficult for SMEs to graduate from one group to another as they grow.[207] This idea was echoed by Lily Steponaitis, who indicated that there needs to be a clear and smooth continuum of capital for businesses to access at they grow.[208] According to Steponaitis, Toronto has a number of resources available to very early stage businesses, but that the current environment requires large leaps and a significant investment of time to identify and move to the next sources of financing. Additional collaboration between organizations providing capital could make it easier for businesses to move up through the system.[209]

4.4: The Role of Risk Perception & The Risk / Return Trade-off

One of the factors that underlies many of the market gaps outlined above is risk perception. The discussion below will outline the reasons that traditional lenders view SMEs, non-profits, social enterprises and vulnerable populations as high risk borrowers.

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[205] Morris, Interview by author.
[206] Dea, Interview by author.
[207] Identity Confidential, Interview by author, January 31, 2019.
[208] Steponaitis, Interview by author.
[209] Steponaitis.

Risk Perception

Small Businesses

Small business face funding difficulties for multiple reasons. The first of these relates to a lack of collateral. Traditional banks, and perhaps even credit unions, aren't willing to lend to small businesses because they often don't have adequate collateral to cover loans.[210] This makes these loans appear riskier, because it means that these lenders are partially unsecured or relying on a general securities agreement to repay their loans in the event of default.[211]

A second reason that some small businesses have difficulty accessing credit, is due to a reliance on personal credit scores in the risk assessment process. As financial institutions continue to increase loan volumes and approval speed, more are relying on personal credit scores as a deciding factor in the loan approval process.[212] This reliance on personal credit scores as a measure of risk is in part rational. When small business loans default, their corporate assets often end up being diluted or gone, and so the main source of repayment tends to be the individual borrowers themselves.[213] The problem is that this credit score is based on an individual's financial strength, and is not indicative of the strength of their business plan or expected future performance of the venture.[214] When making a loan to a small business, lenders are essentially looking at a business model in the absence of operating history, assets and profit, which is riskier than lending to an established or larger business.[215]

A third reason that small businesses may have difficulty accessing credit is that their operations are often specialized, innovative or local. These factors may make the loan review process more difficult, as it is harder for a lender to fit the application into a standard format. In these cases, the lender often requires specific market expertise in order to appropriately assess loan applications.

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[210] Baker, Interview by author.
[211] Baker.
[212] Identity Confidential, Interview by author, February 20, 2019.
[213] Identity Confidential.
[214] Identity Confidential.
[215] Identity Confidential, Interview by author, January 31, 2019.

Non-Profits & Social Enterprises

Similarly, traditional lenders associate a high level of risk with non-profits or social ventures. Values-aligned businesses tend to invest a portion of their profits back into the community or their employees, leading to thinner profit margins.[216] Thinner profit margins means fewer corporate assets, and a limited financial cushion if the business experiences difficulty. For non-profits, an additional consideration is their grant or donation revenues. These cannot be considered a stable source of revenue, as they can change over time, compounding the risk in terms of the sustainability of a non-profits' operations.[217]

These issues are clear in the Canadian market. According to the Social Innovation and Social Finance Strategy Co-Creation Steering Group's 2018 report, the Canadian market is suffering from a lack of specialized financial intermediaries who understand and are able to accurately assess the risk profiles of social purpose organizations. In addition, the report noted that while there may be a high degree of investment interest in social finance, there are few investors who are willing to put their capital at risk because the nascent market's limited return history makes it difficult to assess real risk.[218]

Vulnerable Populations

Finally, vulnerable populations are also viewed as riskier borrowers through a traditional risk assessment lens. For example, borrowers at Rise Asset Development, who have faced barriers to employment due to mental health or addiction issues, often also struggle with poor credit, few assets and low income.[219] For Windmill Microlending, an organization that lends to recent immigrants or refugees, their borrowers would have difficulty getting loans through traditional lenders due to a lack of or poor credit history.[220]

[216] Baker, Interview by author.
[217] Collins-Swartz, Interview by author.
[218] Social Innovation and Social Finance Strategy Co-Creation Steering Group, "Inclusive Innovation," 28.
[219] Dea, Interview by author.
[220] Morris, Interview by author.

Risk/Return Trade-off for Values-Based Lenders

As discussed in Chapter 2, when deciding whether or not to make a loan, lenders need to balance the credit risk with the potential return. For traditional lenders, a key consideration is charging an appropriate interest rate to compensate for the risk that they are taking. For the populations mentioned above, the high risk perception would result in these borrowers being charged high interest rates. In some cases, the risk would be considered high enough that a lender might not make the loan at all. However, for values-based lenders, the relationship between risk and return was not always linear.

Some organizations interviewed did charge interest rates that were relatively consistent with what a traditional bank might charge, albeit for loans that a traditional lender might perceive as too risky to make. These tended to be chartered banks, credit unions and for-profit lenders, where money was coming from depositors or investors who were expecting a market rate of return. There is a sound rationale for values-based lenders charging higher interest than traditional banks. Lily Steponaitis compared values-based lenders to local boutiques, who charge higher prices for quality, handmade, or ethically-sourced goods. The high interest rates reflect both the higher risk and the transaction costs of the loans, which is necessary because values-based lenders may not be able to manage and absorb losses like large financial institutions.[221]

Other lenders charged interest rates that were well below market. These tended to be community loan funds, where the source of funds was governments, foundations, or patient investors. In some of these cases, the interest rates charged were not consistent with the perceived risk. As Beth Coates used to tell members at the Canadian Alternative Investment Cooperative, "we're returning you a riskless rate of return for having taken risk to do good".[222]

Another key theme here was the values-based organizations' perception of profitability. For traditional lenders, profitability is closely linked to the risk/return trade-off. Lenders want to charge high

[221] Steponaitis, Interview by author.
[222] Coates, Interview by author.

enough interest rates on loans to at least compensate them for the credit risk they are taking, while only lending to borrowers that they judge are likely to repay. Values-based lenders had a very interesting take on the idea of profitability. Several interviewees indicated that they don't think about profitability, but instead about sustainability. None of the values-based lenders interviewed indicated that they had a minimum profitability threshold. Lenders needed clients to repay the loans, and to earn sufficient interest income to cover their overhead expenses, but many weren't focused on maximizing additional profits. For example, at New Market Funds, they need to ensure that the projects they lend to are sufficient to cover expenses, but they put client satisfaction and sustainability of the organization at the forefront rather than financial return maximization.[223] An employee at one community development lender described the organization's approach to profitability as "we are essentially profit-seeking but we don't have to be profit-maximizing, and that's different from a normal bank."[224]

Part of this relationship between profitability and sustainability related to how values-based lenders viewed repayments of loans. Traditional lenders want borrowers to keep loans out for long periods of time, to increase interest income and amortize upfront transaction costs. For these reasons, many lenders even charge penalties for early repayment of debt. Values-based banks had a different take on loan repayment. Many encouraged loan repayments, as this meant that the same capital could be redeployed to help other borrowers in need. At Windmill Microlending, they are happy to have clients repay their loans early if they finish their certification programs, as they recognize that this is in the best interest of the client, and that the money can be lent out again to another newcomer.[225] Beth Dea, COO at Rise Asset Development, says they try to include this idea in communication to clients, noting "by paying your loan back, you're paying it forward".[226] For Beth Coates, instances where the Canadian Alternative Investment Cooperative had to

[223] Baker, Interview by author.
[224] Identity Confidential, Interview by author, January 31, 2019.
[225] Morris, Interview by author.
[226] Dea, Interview by author.

write a loan off were the organization's "greatest failure" because they weren't able to lend the money to another group in need.[227]

[227] Coates, Interview by author.

CHAPTER 5: THE IMPORTANCE OF RELATIONSHIPS

The previous chapter outlined the various types of organizations currently providing loans to the Toronto SME market, explored what factors made these lenders "values-based", and identified a number of gaps left by traditional lenders that these values-based organizations have been created to fill. This chapter will focus on the importance of community and customer relationships for values-based lenders. In Chapter 3, I hypothesized that values-based lenders might prioritize these relationships in the lending process, due to the organizations' social purpose. The idea was that stronger ties to clients and communities, in additional to lower organizational emphasis on profit, might lead values-based lenders to attribute lower credit risk to SME borrowers. As explained previously regarding the trade-off between risk and return, a lesser risk perception might enable values-based lenders to provide SMEs with better loan terms than traditional banks.

5.1: The Role of Relationships in Values-Based Lending

Formation of Relationships

Relationship lending is not exclusive to values-based lenders. Traditional banks, especially in the Canadian context, also rely on the formation of relationships. However, values-based lenders seem to form and foster these relationships in a different way. According to Lily Steponaitis, values-based lenders tend to invest more time and energy in developing relationships with potential clients, even if they are not yet able to help them financially.[228] According to Steponaitis, a general theme in the banking industry has been that traditional lenders will simply turn clients away if they fall outside of their guidelines. Values-based lenders, on the other hand, will try to foster ongoing relationships, working with businesses to refer them to other partners who may be able to help, or encouraging them to come back and check in when the business

[228] Steponaitis, Interview by author.

is more developed.[229] Based on comments from interviewees, client relationships with values-based lenders seem to start earlier (in some cases, well before a loan is made), and involve more ongoing support.

While the importance of relationships in values-based lending was widely recognized, the importance of in-person interaction when establishing a relationship seemed to be up for debate. Several interviewees noted the importance of in-person interaction with their clients. The microlending program at one credit union puts a strong emphasis on the in-person interview, and while they are moving towards a digital platform that would collect information online, they are still thinking about ways to incorporate an in-person element.[230] At ACCESS Community Capital Fund, the loan review committee prefers to conduct in-person interviews with applicants.[231] However, this in-person requirement was not the case for all institutions interviewed. Some offered loan products that could be accessed entirely online. BDC, for example, offers a loan program where applicants can apply for as much as $100,000 through a "100% online application".[232]

The Use of Relationships in Assessing Credit Risk

The hypothesis that values-based lenders rely on customer and community relationships when assessing credit risk seemed to hold true in many cases. In terms of credit risk assessment, values-based institutions generally still looked at traditional credit risk measures (e.g. collateral, past financial performance, financial ratios, credit score). However, as discussed earlier, many acknowledged that these were not helpful measures of risk for their target populations, and had to be augmented with different metrics. These metrics were generally more qualitative and subjective than many of the loan assessment tools used in traditional lending. In addition, the majority were linked to either the relationship between the lender and the client, or between the client and their respective communities.

[229] Steponaitis.
[230] Identity Confidential, Interview by author, February 28, 2019.
[231] ElSayeh, Interview by author.
[232] Business Development Bank of Canada, "Business Loans."

Some of the non-traditional credit risk determinants that overlapped between interviews were:

i. **Qualifications, Experience and Soft Skills of Management Team and/or Board of Directors:** While this is something also looked at by traditional lenders, this becomes even more important in relationship lending.

ii. **Story Behind the Loan:** Beyond just looking at the numbers, values-based lenders want to understand the context. For example, according to an employee at one credit union, most underwriters at the organization will start a credit application review with the "notes" section, before jumping to any of the quantitative analysis.[233] For Windmill Microlending, a belief in an applicant's story and learning plan can, in some cases, be enough to overcome other financial risk factors.[234]

iii. **Business Plan and Expected Future Performance:** Instead of focusing on the assets or financial history of a borrower, values-based lenders tended to focus more on expected future performance. Jane Bisbee, Executive Director at the Alberta-based Social Enterprise Fund, likened the organization's approach to credit risk assessment to that done by angel investors, as the majority of clients have no assets or are operating in a new sector.[235] The fund looks at an applicant's mission and the feasibility of their projected revenue stream, in addition to strength of the management team. As another example, Rise Asset Development considers viability of the business plan, in terms of customer base and sales pipeline, when assessing credit risk.[236]

iv. **Personal Experience and Support Factors:** As noted previously, many of the interviewees referred to themselves as "character-based" lenders, relying on more subjective information gleaned through interviews and character references. For example, a large part of the credit risk assessment at Rise Asset Development is what they call the "personal readiness" of an applicant,

[233] Identity Confidential, Interview by author, January 30, 2019.
[234] Morris, Interview by author.
[235] Bisbee, Interview by author.
[236] Dea, Interview by author.

which involves looking more broadly at their life and family situation and support networks.[237] Windmill Microlending assesses applications across a number of "risk buckets", including things like life situation risk, family risk, and learning plan risk, in additional to financial risk.[238]

The Use of Relationships in the Loan Approval Process

Although there was some overlap in risk assessment tools, the loan decision making process differed significantly across interviewee organizations. There appeared to be a link between organization size and decision making authority level, meaning that larger organizations would approve loans at a higher level, however this was likely also linked to the size of the loans (i.e. larger organizations were making larger loans, and thus needed a higher level of authority to sign off). In general, the chartered banks, credit unions, and for-profit investors employed a credit committee which had the ultimate authority in terms of lending decisions, and which operated independently of the group responsible for analyzing and originating the loans. Some of the smaller organizations made loan decisions internally. For example, the Alberta-based Social Enterprise Fund analyzes and approves all loans within their two person team.[239]

Several of the community loan funds also had independent committees to review applications and make loan decisions, but these tended to be comprised of diverse groups of volunteers, in many cases members of the local community. Several examples included:

- Rise Asset Development has a 12 person volunteer investment committee that approves loans over $2,500, and includes a diversity of perspectives in terms of geography, industry, experience level, culture and age.[240]
- The Canadian Alternative Investment Cooperative had an advisory board made of up community members with different backgrounds and areas of expertise.[241] Interestingly, one step in the credit process involved a meeting between the advisory board and the loan applicant themselves, at the

[237] Dea.
[238] Morris, Interview by author.
[239] Bisbee, Interview by author.
[240] Dea, Interview by author.
[241] Dea.

end of which the advisory board would make a recommendation to the Board of Directors to either approve or decline the loan.[242]

- ACCESS Community Capital Fund has a loan review committee that is responsible for credit risk assessment and lending decisions, which is made up of volunteers that encompass a wide range of perspectives to address issues of equity, diversity and poverty.[243]

Community relationships, and even relationships between clients, played into the loan decision making process at many of these institutions. For example, at the Canadian Alternative Investment Cooperative, many of the investors were Roman Catholics. From their perspective, the church was about making the world a better place and promoting social justice.[244] At CAIC, there were situations where an investor would actually guarantee a loan or subsidize the interest rate when they felt strongly about the borrower's mandate.[245] In addition, according to Beth Coates, Financial Manager at CAIC, if an organization was referred by a member or past borrower, it meant they were part of a network, which helped when trying to gauge their risk.[246] She described risk assessment as "a kind of a knowledge gathering process", and these referrals and recommendations from entities known to CAIC were helpful in trying to get an understanding of someone's character in character-based lending.[247] Jane Bisbee, Executive Director at the Edmonton, Alberta-based Social Enterprise Fund, also noted the importance of community knowledge in lending and risk assessment. From her perspective, it was even different to make a loan in Calgary (another city in Alberta) versus Edmonton, because as a local lender they are privy to the backstory of loan applicants in Edmonton.[248] While the fund could technically lend outside of Alberta, she noted that

[242] Coates, Interview by author.
[243] ElSayeh, Interview by author.
[244] Coates, Interview by author.
[245] Coates.
[246] Coates.
[247] Coates.
[248] Bisbee, Interview by author.

she would be uncomfortable lending somewhere like downtown Toronto, because the needs of the community are so different.[249]

Community relationships can have an even more direct impact on access to credit, in the case of community bonds. Ryan Collins-Swartz, Social Impact Manager at Tapestry Community Capital, indicated that strong community relationships, in addition to strong finances, means a group will likely be more successful in issuing a community bond.[250] These strong community relationships can even have spillover effects on access to other types of debt. For example, in some cases, one Canadian community development lender has treated community bonds as "quasi-equity" (as opposed to treating them as traditional debt, which is a liability on the balance sheet of the borrower) when making lending decisions, as long as the bonds are subordinated and the borrower can service the interest.[251] They actually view the ability to raise a community bond as evidence of an organization's social capital.[252]

Client Relationships as Referral Source

In addition to their clear value in assessing credit risk and making lending decisions, strong relationships also offered values-based lenders the additional benefit of acting as a source of new customers. When compared to personal banking, small businesses tend to have stronger and less fractured relationships with their financial institutions, maintaining fewer accounts with a smaller number of institutions.[253] While this makes gaining a small business as a client beneficial for a lender, in that they may be able to offer a client a range of additional services, the client can also act as a source of new business referrals. Many small businesses are part of networks with other similar businesses, and are likely to discuss a positive lending experience with other members of their networks.[254]

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[249] Bisbee.
[250] Collins-Swartz, Interview by author.
[251] Identity Confidential, Interview by author, January 31, 2019.
[252] Identity Confidential.
[253] Identity Confidential, Interview by author, January 30, 2019.
[254] Identity Confidential.

Interviewee comments indicated that for these values-based lenders, relationships were an essential source of new business. As many were small and had limited resources, the ability to attract new clients via existing relationships was key. Part of this involved relationships with existing or past customers. For one community development lender, the organization's current sub-commercial scale and values-based mandate means they need to rely on their relationships to advocate on their behalf to potential new clients.[255] For Windmill Microlending, one of the best referral sources is word-of-mouth from past borrowers, making it important that all clients have a positive experience and want to refer other members of their network.[256] For other lenders, the importance of relationships as a referral source extended to relationships with their investors. According to Beth Coates, Financial Manager at CAIC, the organization used to say that "our best borrowers often come from our members."[257] As CAIC had a very narrow and deep mandate, they relied on their members/investors to help find interested borrowers and act as part of their "broadcast system".[258]

The Need for Two-Way Relationships

As the term implies, relationships with clients and communities need to be two-way, and involve benefits and obligations for both parties. For values-based lenders, this seems to go beyond just bearing the financial risk of a loan. One example, provided by Lily Steponaitis, was the example of lending to a church. Traditional lenders shy away from making loans to churches because of the negative public perception of having to take possession of the church in the event of default.[259] In this case, a values-based lender needs to be willing to take on this role, in order to make the loan and provide the organization with the help it needs.[260] Christina Baker, Director of Community Lending at New Market Funds touched on this tension in her interview, noting that having a full relationship between a borrower and lender can be difficult, and

255 Identity Confidential, Interview by author, January 31, 2019.
256 Morris, Interview by author.
257 Coates, Interview by author.
258 Coates.
259 Steponaitis, Interview by author.
260 Steponaitis.

it is important to set clear standards.[261] At the end of the day, if the borrower were to default, the lender will need to collect on the loan.[262]

In values-based relationship lending, there also needs to be a commitment from the borrower for the system to work. Lily Steponaitis noted that it can be challenging when a values-based lender invests significant time and resources working with a client to get them to a point where they are able to make a loan, and then that client chooses to work with another lender who can offer a lower interest rate.[263] For Steponaitis, the role of a financial institution is not to give out easy money, but to forge sustainable relationships and strong local economies, something that requires the help of both lenders and borrowers.[264] For values-based lending to be sustainable, and for these lenders to be able to continue investing time and resources to build relationships, values-aligned borrowers need to reciprocate by being willing to invest time and resources on their end as well.

The Downside of Relationship Lending

While both lenders and borrowers can benefit from the presence of strong relationships, these connections can also pose challenges. One such challenge is the bias that relationships can bring into credit decisions. For example, when assessing the reputation or credibility of a potential borrower's Board of Directors, a lender's personal connection or similar background might lead to a biased decision.[265] Mona ElSayeh, Executive Director at ACCESS Community Capital Fund, noted the potential conflict of interest if relationships with a customer or community were to impact their access to credit.[266]

A number of interviewees have instituted processes to limit these biases in lending decisions. At Windmill Microlending, a client can appeal a declined loan through a board committee, which involves

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[261] Baker, Interview by author.
[262] Baker.
[263] Steponaitis, Interview by author.
[264] Steponaitis.
[265] Identity Confidential, Interview by author, January 31, 2019.
[266] ElSayeh, Interview by author.

getting a new group of people to look at the situation and re-examine the decision.[267] Another credit union has a policy that no loan can be immediately declined, in order to eliminate any bias and ensure that at least one other person reviews details of the application.[268] At ACCESS Community Capital Fund, the loan review committee is not privy to whether or not a loan was referred from a community agency (e.g. settlement agency or entrepreneurship centre).[269]

5.2 Lending Ecosystems: Networks of Relationships

The idea of relationships for values-based lenders seemed to extend beyond just bilateral relationships between a lender and a borrower, or between a lender and a community. A term that came up during multiple interviews, entirely organically, was “ecosystem”. The use of this term may have been a result of its inclusion in the Social Innovation and Social Finance Strategy Co-Creation Steering Group’s 2018 report, where the word ecosystem was used to describe “networks of relationships” between individuals and organizations using social innovation and finance to foster sustainability and inclusivity in their communities. This report focused on the role of government in supporting these ecosystems, through efforts related to capacity building, funding, market access for social enterprise, regulations, knowledge sharing and awareness.[270]

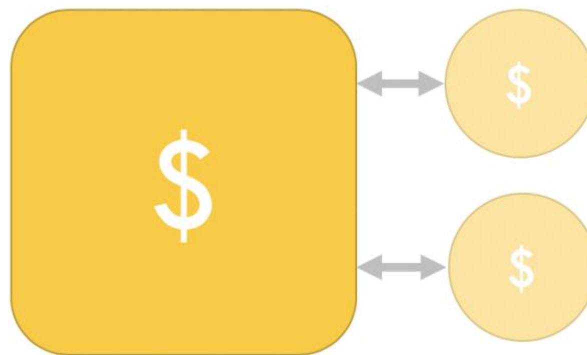
Based on interview data, it appeared that lenders could be a part of three distinct types of relationship ecosystems: i) capital ecosystems; ii) customer service ecosystems; and iii) entrepreneurial ecosystems. In each of these ecosystems, the lender played a critical role, however that role differed between the type of system. Many of the interviewees worked for lenders that were a part of several different ecosystems.

[267] Morris, Interview by author.
[268] Identity Confidential, Interview by author, January 30, 2019.
[269] ElSayeh, Interview by author.
[270] Social Innovation and Social Finance Strategy Co-Creation Steering Group, “Inclusive Innovation,” 2.

i. Capital Ecosystems

In the capital ecosystem, the lender played the role of **partner** to other financial institutions. The strength of these partnerships varied. Some were more akin to a referral arrangement, while others involved a linkage of funding or back-end loan management functions. These partnerships tended to be mutually beneficial, helping to advance the goals of both lenders.

Figure 6: Diagram of a Capital Ecosystem



Several examples of capital ecosystems in the Toronto market include:

- One credit union has a partnership with six different community loan funds, providing them with services ranging from loan origination to loan administration. This arrangement is a mutually beneficial one. The credit union gains a larger client base and an improved knowledge of local communities, while the arrangement provides the community loan funds with increased legitimacy and the ability to charge lower interest rates on loans.[271]
- BDC, in concert with an anonymous family foundation, provides the loan capital for Rise Asset Development.[272]

[271] Identity Confidential, Interview by author, February 28, 2019.
[272] Dea, Interview by author.

- ACCESS Community Capital Fund started providing professional development loans for internationally-trained professionals to recertify in Canada several years ago, and they partner with Windmill Microlending to serve this population.[273]
- In the case of community bonds, bonds typically finance only 10-60% of the total cost of a project, and issuers need to partner with other values-based lenders in order to get a project financed.[274]

While some of the partnerships were deep-rooted, and engrained into the organizations' respective business models, others were more referral oriented. In these cases, the capital ecosystems seemed to provide a marketing function for lenders. This differed from referrals coming from past customers or investors, as the referrals in the capital ecosystems were actually coming from other financial institutions. As lenders were members of these partnerships or referral networks, they gained exposure and attracted new clients through other members. Many of the interviewees worked for small organizations with limited resources and capacity, and so had to rely on their partners to find clients.

These partnerships seemed to change the nature of the competitive landscape between financial institutions. While traditional banks tend to compete with each other, playing a zero-sum game and trying to win market share from their competitors, the values-based mentality seemed to be more akin to expanding the market by providing financial services to otherwise unserved or underserved populations. In the words of one interviewee, "the thing that keeps me up at night, if anything, is the idea that like all we literally do is like take a card from Meridian's deck and put it in ours, and oh a CIBC card, and […] we're kind of all shuffling each other's cards […] versus actually talking to this whole outer orbit, or outer outer orbit that just, that actually needs the help."[275] This change in mindset allows for co-operation and mutual reliance between lenders, even between values-based lenders and traditional lenders, because they are not trying to serve the same market.[276]

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[273] ElSayeh, Interview by author.
[274] Collins-Swartz, Interview by author.
[275] Identity Confidential, Interview by author, January 31, 2019.
[276] Identity Confidential.

ii. Customer Service Ecosystems

In the customer service ecosystem, the lender played the role of **connector**, linking or referring borrowers to providers that could meet some other, non-financial need. The referrals were two-way, with the lenders referring clients to service providers or community organizations in some cases, and clients being referred to the lender from these entities in others. Each member of the ecosystem was responsible for a relatively narrow scope of service. However, it was the strong linkages and referral networks between these related organizations that allowed them to provide fulsome solutions to customers.

Figure 7: Diagram of a Customer Service Ecosystem

Some examples of customer service ecosystems in the Toronto market include:

- One credit union has developed both formal and informal relationships with community organizations such as newcomer centres and employment centres, who can provide clients with education and training related to business plans, financial literacy, and mentorship opportunities.[277]
- Rise Asset Development has what they call "business advisors", who act as Rise representatives at partner organizations (e.g. employment agencies, mental health agencies) to connect with other community organizations and actually help potential borrowers work through the Rise application

[277] Identity Confidential, Interview by author, February 28, 2019.

process.[278] In addition, Rise relies on corporate partnerships to help spread the word, such as Bell Let's Talk.[279]

- Windmill Microlending has integrated themselves into the broader ecosystem of resource providers for internationally-trained professionals (e.g. educational bridging programs, professional regulatory bodies, private coaching companies, employment counsellors, settlement agencies), allowing them to both receive and provide client referrals from these entities at the appropriate time and depending on the needs of the client.[280] Windmill themselves are only providing loans for education programs, a narrow service but one that is very necessary for some newcomers to be able to achieve their goals.[281] Specifically, one program at the University of Toronto now automatically provides accepted students with information about Windmill's lending programs, as they understand how essential this funding is for potential students.[282]

From my perspective, the "values-based" ecosystem is another example, or subset, of the customer service ecosystem category. Based on interview data, the values-based ecosystem involved connecting or providing clients with information about other product or service providers who were "values-aligned". As discussed previously, values-aligned procurement was a recurring theme among interviews, with some lenders sourcing things like company clothing, office equipment and catering from ethically-minded suppliers and social enterprises. The values-based customer service ecosystem takes this one step further, by looping the customer into the system. An employee at one community development lender noted the organization's need to "be better embedded in […] the full ecosystem of resources in the market for social purpose organizations, regardless of type", and be able to connect their customers with values-aligned professional service providers (e.g. consultants, tax experts, real estate developers, marketing agencies etc.)

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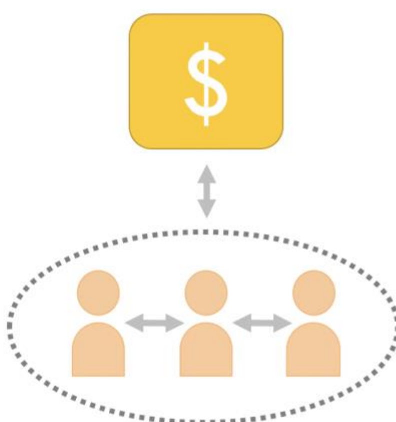
[278] Dea, Interview by author.
[279] Dea.
[280] Morris, Interview by author.
[281] Morris.
[282] Morris.

when appropriate.[283] According to the interviewee, part of this needs to involve first establishing and strengthening the connection between values-based lenders and other professionals so they can be mutually comfortable referring clients.[284]

iii. Entrepreneurial Ecosystems

The final category of ecosystem was the entrepreneurial ecosystem. In this case, the lender acted as **facilitator**, bringing together SME clients to foster networks between businesses.

Figure 8: Diagram of an Entrepreneurial Ecosystem



Several examples of entrepreneurial ecosystems in the Toronto market include:

- Rise Asset Development hosts gatherings for peer support between their borrowers, and allows clients to meet each other and identify ways in which they can help other business endeavors.[285] Rise clients tend to be socially minded because of the difficult situations they have been through, wanting to hire and people facing similar difficulties.[286] According to Beth Dea, COO at Rise, "I bet you our clients, we've never asked them this question, but I bet a lot of them would consider themselves social enterprises themselves, even though it's a for-profit business".[287]

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[283] Identity Confidential, Interview by author, January 31, 2019.
[284] Identity Confidential.
[285] Dea, Interview by author.
[286] Dea.
[287] Dea.

- The Social Entrepreneurship team at BDC hosts events for B-Corp entrepreneurs to meet each other and network.[288]

The presence of a lender as a facilitator in an ecosystem of SMEs provides a unique opportunity. Beyond just forging connections between like-minded individuals, they also have the potential to form connections between clients in conflict. One interviewee pointed to case where a lender had relationships with two organizations with conflicting perspectives. One was part of a real estate development perceived to be contributing to gentrification, and another was an organization fighting gentrification in the same neighbourhood. The interviewee wondered about the potential role of a lender to form connections between organizations with different stances, as a way to try and find productive solutions that are acceptable to both parties.[289]

5.3: The Impact of Relationships on Credit Risk and Loan Losses

One particularly interesting finding from this research was that on the whole, the values-based lenders interviewed actually had to write-off very few loans due to performance issues. In fact, these rates seemed to be in line with, or only slightly above, traditional lenders. This is surprising, given that they tend to serve borrowers who are perceived as high risk.

Part of this success stemmed from the fact that some values-based lenders had a different definition of loan default or delinquency, taking a different response to a client in financial distress than a traditional lender might. At Rise Asset Development, they write-off about 6% of loans per year (this rate varies from year to year), which they feel is fairly competitive with a bank; however, 30-35% of their total loan portfolio is in some type of restructuring at any time.[290] Rise works with clients who are unable to make loan payments to restructure their payment plan, only writing off a loan when they run out of options.[291] According to Beth Dea, COO at Rise, “we do what we can to make people successful, […] because in the

[288] Ryan, Interview by author.
[289] Identity Confidential, Interview by author, January 31, 2019.
[290] Dea, Interview by author.
[291] Dea.

end nobody wants to default on a loan", indicating the high degree of trust and faith that Rise has in their clients.[292] At the Alberta-based Social Enterprise Fund, Executive Director Jane Bisbee says they think about these situations as a "work-through rather than work-out", trying to partner with the client and take an active role in helping them come up with a solution.[293] The Social Enterprise has only written-off 3 out of 70 projects financed in the past 10 years.[294]

In some cases, lenders were good at predicting which loans were truly high risk. At Windmill Microlending, the loans that tended to default were the same ones that had initially been marked high risk.[295] Sometimes this is because their debt burden was too high to manage, but there were usually some other, non-financial risk factors in the picture (e.g. family issues, illness).[296] For the Canadian Alternative Investment Cooperative, all of the loans that defaulted were those that they viewed as high risk.[297] These tended to be smaller loans ($10,000-$20,000), and were what Beth Coates, Financial Manager at CAIC, referred to as "groans", which were loans that were more like grants in reality.[298] For others, it has been for difficult to predict. For ACCESS Community Capital Fund, it has been surprising to see which loans end up defaulting, as their borrowers are operating with small margins and many are negatively impacted by factors that are very difficult to see coming (e.g. family illness, corporate layoffs).[299]

Some lenders felt that relationships had contributed to low default rates. New Market Funds has a very low default rate of less than 1%, in part due to the time spent building strong relationships with customers.[300] From the perspective of Christina Baker, Director of Community Lending at New Market Funds, this relationship building makes customers more mindful, as they understand that a failure to repay their loan would have spillover effects in that the funds couldn't be lent out again to other socially-oriented

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[292] Dea.
[293] Bisbee, Interview by author.
[294] Bisbee.
[295] Morris, Interview by author.
[296] Morris.
[297] Coates, Interview by author.
[298] Coates.
[299] ElSayeh, Interview by author.
[300] Baker, Interview by author.

organizations.[301] Customers recognize the time and resources that the organization puts into building client relationships, and care about repaying the loan because they really know the lenders.[302] The previously mentioned "wraparound supports" (e.g. education, financial literacy, client check-ins) at one credit union are believed to contribute to the low default rate, in addition to the fact that many loan applicants are being referred through community or employment centres where they can access resources to develop and refine their business plans.[303] The microlending program at this credit union started out with a default rate of around 9%, and this has since been reduced to around 2% through adjustments to the program.[304]

While the bulk of this discussion has been about traditional lending, where a lender provides a loan to a borrower and the lender bears the credit risk of the loan if the client fails to repay, there also appears to be a role for loan guarantees in values-based banking. Loan guarantees (full or partial) allow credit risk to be shared or transferred between financial entities, so they are not entirely borne by the institution originating the loan. Several examples of the use of guarantees in values-based financing include:

- Through the Canada Small Business Financing Program, the Federal Government guarantees a portion of any losses incurred on loans to small businesses made by other lenders.
- At Windmill Microlending, loans are made by borrowing against a line of credit with the Royal Bank of Canada, which is guaranteed by a number of high-net worth individuals.[305]
- ACCESS Community Capital Fund is not actually a lender, but a guarantor, using funds received by investors and individuals to guarantee loans made through other lenders.[306]

In all of these cases, the guarantees do not involve capital being extended to SMEs upfront, but still enable them to access funding on reasonable terms.

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301 Baker.
302 Baker.
303 Identity Confidential, Interview by author, February 28, 2019.
304 Identity Confidential.
305 Morris, Interview by author.
306 ElSayeh, Interview by author.

CHAPTER 6: TENSIONS, CONCLUSIONS & RECOMMENDATIONS

6.1 Key Tensions for Values-Based Lenders

In their operations, the values-based lenders interviewed appeared to face a number of tensions and trade-offs between conflicting aims. These tensions generally arose as values-based lenders were trying to best serve unserved and underserved populations, but they were limited by the need to comply with regulations, grow to a sufficient scale to minimize capital costs, and provide adequate financial returns for their investors. From my perspective, the major tensions faced by Toronto values-based lenders can be summarized as: i) the level of credit risk taken on versus regulatory limits on risk; ii) pressure to grow or scale up versus the desire to develop strong relationships with the customers and communities they serve; and iii) balancing economic sustainability of borrowers with generating financial returns on invested capital.

i. Risk versus Government Regulation

One challenge that values-based lenders serving SME clients face is the regulatory environment, and balancing the lending risks they take on against regulatory and capital requirements.

As previously indicated, different types of financial institutions are regulated by different entities. Clearly, some lenders face a higher level of regulation than others. For those that are highly regulated, they often need to engage in what one interviewee referred to as “portfolio construction”.[307] This means that a lender can make higher risk loans, but that these need to be offset by a large number of lower risk loans.[308]

While the regulating entity changes by type of institution, there is even a spectrum of regulation within a certain class of financial institution. For example, OSFI regulations differ by bank size; smaller banks have higher capital requirements, meaning they need to hold more money on hand for every loan

[307] Identity Confidential, Interview by author, January 31, 2019.
[308] Identity Confidential.

they make than a large bank.[309] This means that they have a higher cost of capital, making lending less profitable.[310] Even just compliance with regulation is expensive for lenders, and smaller values-aligned lenders need to grow lending volumes to be able to afford to meet this regulatory burden.[311]

According to Lily Steponaitis, there is a clear market gap that exists when it comes to financing SMEs, but this gap is challenging for values-based lenders to navigate when being regulated by the same entities that are governing large, traditional banks.[312] Other non-bank institutions that are legally able to take on higher levels of risk, and take a more patient and long-term perspective, may be better suited to serve this group.[313] From her perspective, the regulation of banks and the legal requirements imposed on the organizations means they will generally still operate like traditional banks.[314] This idea was echoed by Jane Bisbee, Executive Director at the Alberta-based Social Enterprise Fund, who indicated that banks have to abide by rules that limit the flexibility of their risk assessment processes.[315]

ii. Scale versus Relationships

Another issue, somewhat linked to regulation, is the tension between the pressure for growth and the ability to invest time and resources in individual relationships. Many values-aligned lenders tend to be smaller than traditional banks, and as such tend to make smaller and therefore less profitable loans. For example, the Canadian Alternative Investment Cooperative did not historically make money lending to social enterprises, because the transaction costs for these small loans (e.g. legal work) were just as high as those of larger loans.[316] Even for larger values-aligned lenders, loans in the social finance sphere tend to be

[309] Identity Confidential.
[310] Identity Confidential.
[311] Identity Confidential.
[312] Steponaitis, Interview by author.
[313] Steponaitis.
[314] Steponaitis.
[315] Bisbee, Interview by author.
[316] Coates, Interview by author.

on a smaller scale than traditional corporate loans.[317] Larger organizations are already served by traditional banks, and it is difficult for values-based lender to match or beat the terms offered by a large bank.[318]

Values-based lenders end up having an incentive to grow, in part due to regulatory requirements differing by institution type and size (e.g. smaller banks being subjected to higher capital requirements than larger banks). While a social finance bank may want to make small, impactful loans, there is a push to make larger loans in the short-term in order grow to a big enough scale that capital requirements are driven down.[319] At this point, lending becomes more profitable, and a values-based lender can then make these small, impactful loans which still remaining sustainable.[320] While this growth is beneficial in that it can reduce the cost of lending, there is a tension. Rapid growth also makes it more difficult to invest time and resources into client relationships.[321] As lenders grow, client offerings tend to be become more standardized and economically efficient, but this standardization comes at a cost. Standardization may result in lenders being less able to personally interact with customers and build relationships, limiting their ability to provide flexible, solutions-oriented financial products. Many of the values-based lenders interviewed were providing non-financial support to clients, which can be costly but is necessary in many cases to build the financial capacity and independence of borrowers.

The idea of cross-subsidization came up in several interviews, as a way for values-based lenders to manage the tension between scale and relationships. Cross-subsidization in this context means that the profits from more lucrative revenue streams are used to offset the limited or negative profits from other revenue streams. This cross-subsidization makes it possible for an organization to make loans that they otherwise couldn't, due to poor economics (low interest revenue coupled with high transaction costs). For example, at the Canadian Alternative Investment Cooperative, loans to social enterprises were cross-

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[317] Identity Confidential, Interview by author, January 31, 2019.
[318] Identity Confidential.
[319] Identity Confidential.
[320] Identity Confidential.
[321] Identity Confidential.

subsidized by profits on charitable lending.[322] One interviewee at a Canadian community development lender noted that they cross-subsidize small, low-margin, high-impact loans with more profitable, large loans, such as social purpose real estate loans.[323] The interviewee also noted clean energy lending as an area with larger and more profitable loans, that could make it possible to cross-subsidize smaller, high-impact loans that traditional lenders fail to provide.[324]

iii. Profitability for Investors versus Sustainability for Borrowers

Finally, lenders experience a tension between profitability for investors, versus sustainability for borrowers. As discussed earlier, the drive for short-term profitability incentivizes lenders to make larger loans, on more standard terms, with fewer resources dedicated to building client relationships. However, this directly impacts the sustainability of the SMEs doing the borrowing. The push for larger loan sizes means SMEs have a harder time accessing credit. More standard loan terms make it difficult for lenders to use qualitative, character-based lending criteria, and renders them unable to offer flexible financing solutions that may be necessary for a borrower's business model to work. Investing less time and money in developing relationships means lenders have limited soft information about their customers, and borrowers miss out on non-financial services (e.g. business plan coaching, mentoring) that may be critical to the future success of their ventures.

Looking at values-based lenders specifically, most seemed to prioritize sustainability over profitability. This meant that they were more concerned that the financial solutions they provided helped to achieve the social or environmental impact goals of their clients over the longer-term, by providing small loans, customized and flexible terms and investing significant resources in customer relationships. This is in opposition to the mindset adopted by traditional financial institutions, who aim to maximize financial returns for their investors or depositors.

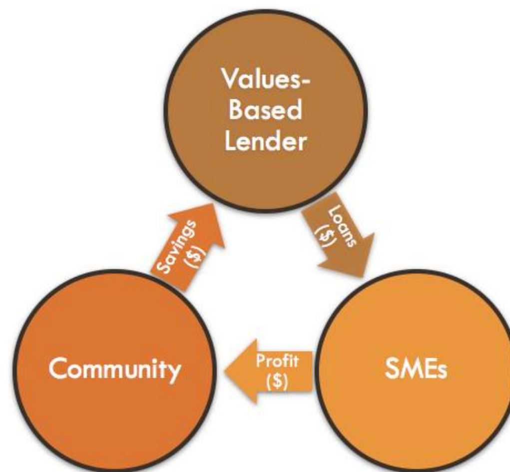
[322] Coates, Interview by author.
[323] Identity Confidential, Interview by author, January 31, 2019.
[324] Identity Confidential.

Values-based lenders may be able to prioritize sustainability over profitability, as many seem to benefit from more of an alignment between their source of loan capital (the party bearing the risk loan losses), and ownership of the lending organization (the party getting the profit) than traditional lenders. For many of these lenders, it was members of the community putting loan capital at risk, and the benefits also accrued back to the local community (refer to Figure 9). It is understood that situations where a financial institution is owned by its depositors (i.e. the "mutual" form of ownership) can resolve the "shareholder-depositor" conflict, when it comes to determining the correct risk level for capital.[325] Examples of this alignment between source of capital and beneficiary include:

- Members of a local credit union deposit savings, and any profits made by lending out this capital is distributed back to members or invested in local community activities.
- Local residents purchase community bonds to help a non-profit finance the construction of a new community centre. As the community centre is ultimately owned by members of the community, they share in any future profits, as well as benefitting from use of the asset.
- A community foundation donates to or invests capital in a community loan fund, which then makes loans to vulnerable populations to improve their economic prospects and support financial inclusion.
- Taxpayers fund government programs that make loans, filling the financing gap for higher risk groups not served by traditional lenders. This enables borrowers to start new businesses, contributing to local economic activity and ultimately benefitting communities.

[325] Bhattacharya and Thakor, "Contemporary Banking Theory," 15.

Figure 9: Values-Based Lending Capital Cycle



In the case of traditional, publicly-traded banks, depositors are putting capital at risk, while it is the shareholders (ultimate owners) who profit. There is an inherent conflict of interest between bank shareholders and depositors in non-mutually owned banks; depositors contribute the bulk of capital, but shareholders look for higher returns, and thus take on more risk, than depositors would like.[326] While some depositors may be, or have some relation to, shareholders, these owners benefitting from community loan capital may also have no relation whatsoever to the lender or broader community. This means that a portion of the profits generated from lending activity are taken out of the local economy (refer to Figure 10).

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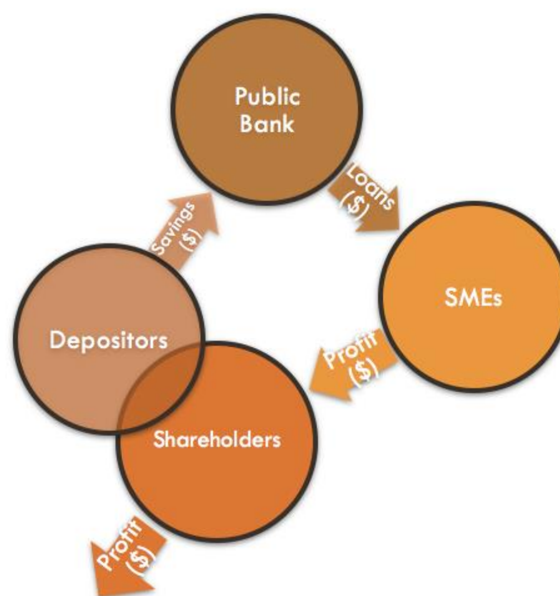
[326] Mullineux, "Banking for the Public Good," 87.

Figure 10: Public Bank Lending Capital Cycle



6.2 Conclusions

Impact Measurement: An Area for Further Exploration

The question of how to measure the social or environmental impact of loans made by lenders was a theme that surfaced in multiple interviews. Several interviewees noted that their respective institutions did a good job at weaving qualitative narratives about impact, but that they do not have formalized processes to measure impact on an ongoing basis. The Social Innovation and Social Finance Strategy Co-Creation Steering Group's 2018 report discussed impact management, noting that work is currently being done to create improved methodologies and metrics.[327] A related area is the concept of impact-linked pricing. As intermediaries, banks have the unique opportunity to influence and promote sustainable economic development. Lenders can assess the potential social and environmental risk of a borrower, and incorporate these risks into the interest rates charged on loans (i.e. higher social and environmental risk would translate

[327] Social Innovation and Social Finance Strategy Co-Creation Steering Group, "Inclusive Innovation," 37.

to higher interest rate).[328] One interviewee pointed to French company Danone as an example, which in 2018 issued one of the largest Positive Incentive Loan ("PIL") facilities ever at €2B. The interest on the loan is linked to the company's ESG rating, as well as the progress of its transition to a b-corp.[329]

Answering the Research Questions

As outlined in Chapter 3, the goal of this thesis was to investigate whether values-based lenders could meet the needs of populations that are unserved or underserved by traditional banks, and improve the accessibility and cost of financing for SMEs in Toronto. I laid out a number of smaller questions to be investigated through the course of this research project, all with the aim of providing an answer to this broader research question. The following section will summarize answers to these questions.

> Q: Who are the values-based institutions lending to SMEs in Toronto, and how do they articulate their goal or purpose?

A: Values-based lenders in Toronto fall across a wide spectrum, in terms of population served, organization type, products offered, and terms provided. They can be generally categorized as chartered banks, credit unions, for-profit lenders, community loan funds, government institutions & programs, and alternative lenders. All of the organizations contacted had a social goal beyond financial performance (either explicitly stated, or implicit in their business model). However, interview data determined there were additional factors that these organizations felt characterized them as "values-based". Values-based organizations tended to have a clear social purpose, employ "character-based" lending techniques, consider the social and/or environment impact of loans, provide complementary non-financial services and resources, have a deep-seated concern for client wellbeing, consider values-alignment procurement of goods and services used in operations, and understand the client appeal of their values-aligned business models.

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[328] Climent, "Ethical Versus Conventional Banking: A Case Study," 2.
[329] BNP Paribas, "Danone's Positive Incentive Financing Strategy."

Q: Is there a market for values-based lending in Toronto? Are there commercial clients who are unserved or underserved by traditional banks, or for whom high interest rates form too much of a burden?

A: There is a clear market for values-based lending in Toronto, as evidenced by the numerous market gaps and unserved/underserved populations identified by interviewees. These gaps include limited access to credit for small businesses, charities, co-operatives, non-profits, vulnerable populations (e.g. newcomers, women, individuals facing mental health and addiction challenges), as well as a lack of flexible/long-term financing solutions and a clear financing progression path for SME clients.

Q: What processes or factors do values-based lenders use to quantify risk for business loans? How do they believe this process differs from traditional lenders?

A: Traditional credit risk assessment tools often have limited use in assessing the credit risk of borrowers for values-based lenders. As such, they tend to employ additional more qualitative, subjective measures, many of which relate to the relationship between the lender and client, or between the client and community. These additional assessment criteria include an understanding of the qualifications, experience and soft skills of the executives and/or board, the context or "story" behind a loan, the business plan and expected future performance of the SME, and the personal experience and external support factors of a loan applicant. For some values-based lenders, the interest rate charged on loans was not in line with the perceived risk of the loan, turning the traditional connection between risk and return on its head. In cases where a lender was charging below market rates, the interest paid by the client was essentially being subsidized by some other entity. For some lenders, profits from more lucrative revenue streams or larger scale values-based lending industries (e.g. social purpose real estate) were used to cross-subsidize values-based lending to SMEs. As banks and credit unions face strict financial regulation, limiting the amount of risk they are legally able to take on, other types of lenders may be better suited to provide values-based credit to SMEs.

Q: What is the role of customer and community relationships in the lending process for values-based lenders?

A: Customer and community relationships have the potential to impact credit risk assessment and access to credit at values-based lending institutions. Relationships with customers and local communities played into the loan decision making process at many of these institutions. Relationships were also a significant source of referrals of new business for values-based lenders. In additional, values-based lenders often seemed to be centrally embedded in networks of relationships. Lenders appeared to play essential roles in three distinct types of relationship "ecosystems": capital ecosystems (lender as partner to other financial institutions); customer service ecosystems (lender as connector to related organizations); and entrepreneurial ecosystems (lender as facilitator of small business networks). Values-based lenders tended to both receive funding from and return profits to community stakeholders, keeping more capital contained within a place-based economic cycle.

Q: What has been the connection, if any, between values-based lending and default rates or loan losses in practice?

A: Loan loss rates for values-based lenders appeared to be on par with, or only slightly above, those of traditional lenders; however, values-based lenders often employed different a different definition of default. Values-based lenders tended to be patient, and able to work with clients to improve their odds of successfully repaying a loan. The ability of values-based lenders to predict loan defaults varied by lender, but some felt that strong relationships had contributed to low default rates.

6.3 Key Takeaways & Recommendations

Prior to returning to graduate school, I spent almost five years working in commercial lending at one of Canada's major domestic banks. As is the case with most publicly traded financial institutions, lending decisions were made based on their financial implications. These weren't always short-term implications. For example, sometimes decisions were made considering the longer-term profitability of a client relationship. However, they were always monetary; the decision to lend to a particular client was not influenced by the social or environmental impact that the loan capital would ultimately make. Clients that were perceived as higher risk, especially smaller ones, were less profitable, and as such suffered when trying to access debt from profit-first institutions. This was a situation that frustrated me, and one that, in part, drove my decision to transition into a more socially-oriented field. I was introduced to the concept of values-based banking while at MIT, and wanted to explore the possibility of using these principles to meet a clear need in the Toronto debt finance market.

It is clear from this research that values-based lenders do indeed play a critical role in Toronto SME finance, filling numerous gaps left unserved by traditional banks. Many values-based lenders appear to able to use more subjective, relationship-based information to assess credit risk and make lending decisions, and the efficacy of this approach is demonstrated through their relatively low loan loss rates. However, these institutions also face challenges in their ability to meet the needs of SME customers at scale under current regulatory and economic conditions.

Limitations of Existing Values-Based Lenders

- Values-based lenders who get their loan capital from investors requiring minimum financial returns must charge interest rates that are on par with, or even above, market rates, in order to be able to cover their costs and still make a reasonable return for investors. This need for a certain level of profitability makes it difficult for them to serve the SME market. If they are able to do so, they often need to cross-subsidize loans to SMEs with larger, more profitable loans. There are some socially or environmentally conscious industries, such as social purpose real estate and clean

energy, where loans involve large dollar amounts. However, given the relatively small size of the Canadian market, these opportunities are limited. It is likely that in order to effectively meet the needs of SME customers, these lenders would also need to lend to traditional commercial and corporate clients to generate profits at sufficient scale, limiting their ability to enact positive social and environmental change.

- Values-based lenders who are regulated like traditional banks and credit unions also face similar scale challenges. However, their issues are predominately linked to risk as opposed to profit. As mentioned previously, these highly regulated lenders face a high cost of capital and legal limitations on their portfolio risk. In order for them to make loans to SME customers, they need to undertake a significant amount of portfolio construction to balance high risk loans with large volumes of lower risk loans. As such, these lenders tend to have smaller, values-aligned groups, operating within more traditional lending institutions (e.g. banks or credit unions).
- Values-based lenders who get their loan capital through more patient investors or donations do not need to ensure a minimum financial return on their loans, beyond making sufficient profit to cover their costs. As such, they seem to be able to provide loans to the SME market quite effectively. However, they face limitations in terms of the amount of patient capital that exists in the Canadian market. There is only so much money that donors or investors are willing to allocate towards social or environmental causes, which makes it difficult for these institutions to reach sufficient scale to serve the entire Toronto SME market.

These combined challenges mean that the values-based lenders operating in the Toronto market, whether financed by investment, donation, or government grants, are all able to provide loans to SME customers, but collectively may be unable to make enough loans to meet the significant debt needs of the overall market.

Recommendations

While this thesis is largely directed at values-based lenders themselves, the limitations outlined above exist at a higher level than their internal operations. As previously outlined, there is significant variation in the group of values-based lenders currently serving the Toronto market, in terms of factors such as organizational structure, regulation, and source of funds. While I believe all of these values-based lenders can benefit from the improved understanding of how they fit into the broader ecosystems that exist, any solution to the problem of scale needs to occur at a higher level. In my opinion, a multi-pronged approach is necessary to best address the limitations outlined above. As such, my recommendations include:

1. **Require domestic banks to consider social and environmental impact of lending portfolios.** As previously noted, banks are regulated federally, and as such this initiative would need to be undertaken at the federal level by OSFI. As long as these institutions, which dominate the Toronto lending market, are not legally required to incorporate social and environmental considerations into their lending decisions, they will continue to be driven by profit. Instituting some regulatory requirement to consider these factors will begin a shift in the allocation of loan capital towards positive impact. In addition, such regulation may encourage partnerships and sharing of best practices between traditional lenders and values-based lenders. In the United States, financial institutions are regulated under the Community Reinvestment Act ("CRA"). The CRA recognizes that financial institutions need to serve the communities in which they operate, and encourages banks to "to help meet the credit needs of all segments of their communities, including low- and moderate-income neighborhoods and individuals" while still making sound lending decisions.[330] The idea behind this concept is similar to that of inclusionary zoning; in exchange for the privilege of operating in and profiting from a market, suppliers have an obligation to serve all segments of that market.

[330] Office of the Comptroller of the Currency, "Community Reinvestment Act."

2. **More capital, both public and private, needs to be directed towards social finance.** Values-based lenders are relying on investment or donation by groups or individuals who are committed to enacting social and environmental change. In order for these socially-aligned institutions to grow, and provide adequate levels of financing to SMEs, more capital needs to be allocated to the cause. Government intervention in this area has historically been lacking. In Purpose Capital & MaRS' 2014 report on the state of impact investing in Canada, it was found that there have been minimal changes to investment rules or regulations to help foster the supply of capital for impact investment.[331] In addition, there have been few successful examples of government initiatives to direct capital through tools such as taxes, subsidies or intermediation.[332] However, as mentioned previously, several recent government initiatives signal positive progress in this direction. The 2018 report released by the Social Innovation and Social Finance Strategy Co-Creation Steering Group recommended that government "embed a commitment to social innovation and social finance in Canadian legislation"[333], while the recently announced Social Finance Fund will direct hundreds of millions of government dollars to the cause.[334]
3. **More of the capital directed to social finance should be allocated to debt financing.** As discussed previously, the bulk of SMEs rely on either trade financing (i.e. debt from suppliers), loans, lines of credit or credit cards to finance their operating shortfalls. In the Toronto market specifically, 21.8% of SMEs requested debt financing and 30.7% requested trade credit in 2017, while only 0.6% requested equity financing and 2.5% requested government financing.[335] The financing needs of SMEs are clear, and yet, the focus of the financial community still tends to be on tools such as venture capital and accelerator programs. Funding for social finance needs to

[331] Karim Harji et al., "State of the Nation: Impact Investing in Canada," 79.
[332] Karim Harji et al., 78.
[333] Social Innovation and Social Finance Strategy Co-Creation Steering Group, "Inclusive Innovation," 48.
[334] SVX, "Canada Makes a Landmark $800 Million Commitment to Social Finance."
[335] Statistics Canada and Innovation, Science and Economic Development Canada, "Survey on Financing and Growth of Small and Medium Enterprises, 2017," fig. 3,12,13,14.

reflect the real needs of all SMEs, not just start-ups and high-growth investment opportunities. As such, more of the private and government capital allocated to the social finance market should be directed to values-based lenders, both to bolster their stores of loan capital as well as to support the expansion of their programs.

Implications & Future Considerations for Cities

While the recommendations above focus on the federal and provincial scales, there also exists a unique opportunity for values-based lenders to partner with cities in order to further their mutual goals. According to Craig Ryan, Director of Social Entrepreneurship at BDC, in terms of levels of government, municipalities are the ones that care most about inclusive prosperity.[336] Collaboration with values-based lenders can provide cities with numerous benefits, including the creation of new jobs and diversification of businesses.

Collaboration between cities and values-based lenders can also create considerable gains for the lenders themselves. Cities offer values-based lenders a critical mass of population, allowing them to capitalize on economies of scale and trade. In large urban centres, it makes economic sense for institutions to specialize in relatively narrow functions. As discussed earlier, the drive for growth and commercial scale can be detrimental to customer relationships, in that employees have less time and resources to devote to individual clients. However, the existence of strong relationship ecosystems in the Toronto market allow values-based to specialize and partner with other institutions in order to serve customers both wholly and efficiently. Partnerships between financing providers may also allow for innovative risk sharing arrangements between financial institutions, mitigating potential losses for any one organization and potentially lowering borrowing costs for customers.

[336] Ryan, Interview by author.

In order to realize these benefits, however, municipal governments and city planners must consider a number of key questions, including:

- What are the financing needs of local businesses, and are these being met by existing capital providers in the market? If not, what incentives can be offered at the city level (e.g. subsidies, property tax breaks, in-kind support) to more appropriately allocate funds?
- What metrics and tools are in place to measure and reward positive social and environmental impact facilitated by values-based lenders? How can the city make sure that these benefits flow back into local communities?
- Are municipal resources being directed towards programs that help to develop and support the capital, customer service, and entrepreneurial ecosystems that exist within a city?

As demonstrated through this research, values-based lenders clearly have the potential to meet the financing needs of SMEs. However, it is essential that these institutions be appropriately supported by municipal, provincial and federal governments, as well as private sector actors, to allow values-based lenders to sustainably operate at a commercial scale. Values-based lenders have a unique ability not only to provide credit to SMEs that are underserved by the rest of the market, but also to form an integral part of urban small business ecosystems and contribute to the social, environmental and economic sustainability of local communities.

APPENDICES

APPENDIX A: Interview Question Guide

1) It is my understanding that your organization has a values-based or social goal, beyond financial performance. How would you articulate this goal? Are there certain characteristics/features/qualities of your organization that make you a "values-based" lender?

   Listening Cues / Follow-Up Questions:
   - Are your social goals more/less/equally important compared to financial performance?
   - Would you make a loan with zero risk-adjusted profit?

2) Describe the importance of SME lending to your business, and what you as a values-based organization are able to offer SME clients.

   Listening Cues / Follow-Up Questions:
   - Is being "values-based" appealing to SME clients?
   - Are you able to meet some need not served by traditional lenders?
   - Are you able to provide loans on better terms than traditional lenders?
   - Estimated loan volumes to SMEs, and percentage of total loans
   - What does your "average" SME customer look like?
   - Average loan metrics for SMEs
     i. Size
     ii. Term (years)
     iii. Type of loan (e.g. term debt, operating line)
     iv. Purpose of loan

3) Describe your institutional process for credit risk assessment and loan origination for lending to SMEs.

   Listening Cues / Follow-Up Questions:
   - Balance of decision making power between relationship manager and higher level executives
   - Key determinants of credit risk
     i. Insufficient sales or cash-flow
     ii. Insufficient collateral
     iii. Poor or lack of credit experience or history
     iv. Project considered too risky
     v. Business operates in an unstable industry
   - What is the role of "soft" information in credit risk assessment?
   - In your experience, how has actual credit performance over the course of a relationship compared to perceived credit risk at the time a loan was made?
   - How do you think your risk assessment model differs from traditional lenders?

4) How do you think about the role of relationships with customers and community, based on your strategic vision of values-based banking?

   Listening Cues / Follow-Up Questions:
   - Role of:
     i. Customer relationships
     ii. Community relationships
     iii. Social/environmental/economic impact of businesses

- Impact on:
    i. Risk perception
    ii. Access to / terms of credit
    iii. Negotiations in event of default
- Is each customer relationship managed by a single employee, or a team?
- Does length and/or breadth of relationship have an effect on borrower default, or losses related to defaults?

APPENDIX B: Interviewees

- Baker, Christina. Interview by author. Skype, January 29, 2019.
- Bisbee, Jane. Interview by author. Phone, February 11, 2019.
- Coates, Beth. Interview by author. Skype, February 14, 2019.
- Collins-Swartz, Ryan. Interview by author. Skype, February 15, 2019.
- Dea, Beth. Interview by author. In Person (Toronto), February 1, 2019.
- ElSayeh, Mona. Interview by author. Phone, March 29, 2019.
- Identity Confidential. Interview by author. In Person (Toronto), January 30, 2019.
- Identity Confidential. Interview by author. In Person (Toronto), January 31, 2019.
- Identity Confidential. Interview by author. Phone, February 20, 2019.
- Identity Confidential. Interview by author. Phone, February 28, 2019.
- Identity Confidential. Interview by author. Skype, February 14, 2019.
- Morris, Lindsay. Interview by author. Skype, February 13, 2019.
- Ryan, Craig. Interview by author. Phone, March 13, 2019.
- Steponaitis, Lily. Interview by author. Skype, January 31, 2019.

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