

STRATEGIC ANALYSIS OF A RETAIL BANKING FIRM

by

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ABSTRACT

Citizens Bank of Canada is a full service electronic bank that serves its members across Canada through the Internet, telephone banking, 24-hour member service centre, and two retail locations in Vancouver and Calgary. Citizens Bank is a wholly-owned subsidiary of Vancouver City Savings Credit Union, Canada's largest credit union. This paper analyzes the strategic direction of the bank's retail arm, which accounts for roughly three-quarters of firm revenue. Industry dynamics and competitive trends are forcing a migration to a cost-based strategy. Executing this shift in strategy will require a number of significant changes internally within the bank and ultimately a more comprehensive look at the bank's role within its parent company's overall strategy.

DEDICATION

To my husband, Ron...

Thank you for your unwavering support and your ability to make me laugh incessantly over the last two challenging but memorable years.

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1 PRODUCTS/MARKETS & FIRM OVERVIEW

1.1 Firm Description

Citizens Bank of Canada is a full-service electronic or branchless bank that provides financial services to its members (what Citizens Bank calls its customers) across Canada through the Internet, telephone via a 24-hour Service Centre, and two retail locations in Vancouver and Calgary. Citizens Bank has 436 employees, \$1.5 billion in assets, and is headquartered in Vancouver, with satellite offices in Toronto and Calgary. Citizens Bank is a wholly-owned subsidiary of Vancity, Canada's largest credit union.

Citizens Bank offers products and services in both the retail and non-retail banking areas. Retail banking products are targeted at individuals and include savings and chequing accounts, Visa cards, personal loans, residential mortgages, term deposits, Registered Retirement Savings Plans (RRSPs), and a limited selection of third party mutual funds through Citizens' credit union wealth management distribution partner, Credential Financial Inc. On the non-retail side, product and service offerings at Citizens Bank include foreign exchange, commercial mortgages for amounts between \$1 million and \$25 million, and agent or wholesale deposits to investment dealers and brokers.

1.2 Focus of paper

The paper will analyze Citizens Banks' retail strategy given the current industry dynamics and future outlook, as well as internal factors such as organizational competencies and culture. The retail line of business accounted for approximately 75% of gross revenues in 2004.

In 2003, Citizens Bank finalized its five-year strategic plan to take the bank forward to 2008. The strategic plan provides direction in a two key areas: 1) A broadly defined business model for the bank and value proposition for its parent company, Vancity. In relation to Vancity, Citizens Bank provides a vehicle and means for Vancity to grow beyond British Columbia; 2) Five year targets in the areas of member growth, financial sustainability, employee capability and capacity, operational excellence and Corporate Social Responsibility (CSR).

A critical target in the bank's five-year plan is to grow the membership base by 50,000 to a total membership of 70,000 by 2008. Beyond the initial push to acquire retail members during the bank's launch in 1997 and the subsequent conversion of Citizens Trust customers to Citizens Bank in 2002, the bank had primarily grown its retail membership through third party intermediaries such as mortgage brokers and real estate agents for residential mortgages, and through Strategic Alliance partners for personal loans relating to specific purposes such as energy-saving home renovations, dental care, and RRSP contributions through non-lending financial institutions. Strategic Alliances partners receive a referral fee for loans booked with Citizens Bank. Because of this reliance on third party channels, limited investment was made in building the brand's brand presence and marketing direct to consumers.

1.3 Company Background

1.3.1 Ownership Structure & Parent Company Information

Citizens Bank is a wholly-owned subsidiary of Vancity, or Vancouver City Savings Credit Union, Canada's largest credit union with over 300,000 members, \$10.5 billion in assets, and 42 branches throughout Greater Vancouver, the Fraser Valley and Victoria. The bank is the largest subsidiary in the Vancity group of companies.

Other members of the Vancity group of companies include Inventure Solutions Inc, an information technology arm; Real Assets, a socially responsible investment management firm; Vancity Capital Corporation (VCC) specializing in growth capital; Vancity Enterprises (VCE), a real estate developer focused on sustainability; Vancity Insurance Services (VISL); and Vancity Investment Management (VCIM), which specializes in discretionary investment management with a focus on socially responsible investing. Vancity is also associated with the Vancity Community Foundation (VCF) which specializes in community economic development through grants, loans, and technical assistance. The Vancity Group of Companies describes itself as being “guided by a commitment to corporate social responsibility, and to improve the quality of life in the communities where we live and work”. The group of companies employs approximately 2,050 people.

In 2004, consolidated earnings for the Vancity group of companies totalled \$93.6 million¹. Operating earnings from Vancity credit union itself amounted to \$86.8 million in 2004, while Citizens Bank earnings during the same period came to \$6.2 million. Net earnings from operations for the Vancity group of companies were \$57.2 million, up by \$12.7 million from 2003, and return on equity was 13.0%, while the return on average assets was 63 basis points.

1.3.2 Company History

Vancity acquired Citizens Trust Company, a trust company with approximately 50 employees and five branches in the Vancouver Lower Mainland area in 1991. Upon receipt of a federal bank charter in 1997, Vancity converted the trust company into a bank and applied for a new trust registration. Citizens Bank was formed in 1997 to take Vancity's commitment to corporate social responsibility (CSR) and ethics beyond the borders of British Columbia to the national level. Citizens Bank is not only the first branchless bank in Canada, but also is the only bank in Canada

¹ A one-time accounting policy change relating to mortgage prepayment fees added \$18.8 million to earnings in 2004. Source: Vancity 2004 Annual Report.

that publicly states its position on key social and environmental issues such as climate change and increasing access to financial services. With its entry into the marketplace, Citizens Bank offered the premise of competitive rates, great service, and a corporate social responsibility (CSR) mandate unique to the industry.

In 2002, Citizens Trust Company divested its trust custody business, transferred the majority of its assets to Citizens Bank, and ceased its deposit taking operations. Citizens Trust Company essentially now acts as an investment holding company and maintains the minimum level of short-term investments to sustain the minimum regulatory requirements.

Citizens Bank's strategic direction as defined by its vision and mission is:

Vision

To engage people in a different way of banking that contributes to a better world.

Mission

At Citizens Bank, we are driven by our passionate desire to make a difference in the lives of our members and in our communities.

Our mission is to grow our membership by providing world-class financial solutions in a manner that surpasses expectations.

Our competent and caring staff provides "extreme service", where our members are not only listened to, but also heard.

Extreme service refers to a service attitude or orientation which is rooted in the bank's credit union heritage and embodies the values of "people before profits".

1.4 Product and Service Overview

1.4.1 Product and Service Descriptions

As a mature industry, retail banking products and services are relatively homogenous. While there are small variations in the product features such as the number of free transactions allowed

with a particular chequing account, cashable versus non-cashable term investments, and variable rate versus fixed rate mortgages, the overall function served by each product grouping or category (e.g., borrowing to buy a home or car, the ability write cheques and pay bills) is similar across the industry.

The retail banking products and services offered by Citizens Bank include bank accounts and plans, residential mortgages, personal loans, lines of credit, term investments, RRSPs, RRIFs, mutual funds and discount brokerage services.

Personal Banking products include the bank accounts described in Table 1 below, as well as bank cards, and a range of ancillary services such as wire transfers, duplicate statement requests, stop payments, bank drafts, and foreign exchange from the Vancouver retail office location.

Table 1: Bank Account Types

Bank Account	Description
Chequing/Savings Package	Allows unlimited transactions via ATM, Internet, and telephone banking for \$8 per month (which is waived with a minimum deposit of \$1,000)
Investment Account	Unlimited Internet and telephone banking transactions, and 4 free ATM transactions per month.
Ultimate Savings Account	Offers high interest rate of 2.45% ² with unlimited Internet and telephone banking transactions, and 4 free ATM transactions per month.
Gold Club Account	Unlimited transactions with no monthly account fee for members aged 55 years or older.
US Dollar Account	US dollar chequing account for a monthly fee of \$2.50 and \$0.75 per cheque.

² Rate effective April 20, 2005

1.4.1.1 Mortgages

Citizens Bank offers both fixed and variable rate closed mortgages as well as a fixed rate open mortgage, and a cash-back fixed rate mortgage in a variety of terms from six months to seven years. In a fixed rate mortgage, the mortgage rate is locked-in or fixed for the term while a variable rate mortgage fluctuates with the bank's prime rate and is usually priced in relation to prime (e.g., prime minus 75 basis points³). As for the open versus closed terminology, open mortgages can be prepaid at any time without a penalty while for closed mortgages, any prepayments exceeding the regular prepayment terms (e.g., 20 percent of the original mortgage amount per calendar year), are subject to a penalty. The cash back mortgage offers mortgage-holders a cash incentive of two to three percent of the mortgage amount up front for a fixed rate mortgage at terms of three to five years.

1.4.1.2 Visa Cards

Citizens Bank offers a limited selection of Visa cards as summarized in the Table 2 below.

1.4.1.3 Investments

Citizens Bank offers three broad investment options: term deposits, mutual funds, and discount brokerage services.

Term Deposits

Term deposits are interest-bearing deposits with terms of one to five years. Interest may be paid periodically (monthly, quarterly, semi-annually or annually) or may compound and be paid upon maturity. Citizens Banks offers three primary types of term deposits:

- *Cashable*: one year term which is cashable after 30 days

³ A basis point is one hundredth of a percent.

- *Fixed term deposit*: non-redeemable term deposit for terms of one to five years with the option of compound interest or interest paid monthly or annually.
- *Escalator*: a three year term whereby the interest rates increase each year.

Table 2: Visa card offerings

Visa Card	Description
Amnesty International Visa	Citizens Bank donates 10 cents to Amnesty International each time the card is used and will also donate \$20 upon application approval. This card has no annual fee.
Oxfam Visa	Citizens Bank donates 10 cents to Oxfam Canada each time the card is used and will also donate \$20 upon application approval. This card has no annual fee.
Shared Interest Visa	Citizens Bank donates 10 cents to the Shared Interest fund each time the card is used and will also donate \$20 upon application approval. The Shared Interest fund is a corporate donation pool distributed to various charitable organizations based on input from bank members. This card has no annual fee.
Gold Visa	Gold rewards program which allows cardholders to redeem for travel, Citizens Bank products, and merchandise for a \$99 annual fee.
Student Visa	A student version of the Amnesty International, Oxfam, or Shared Interest Visa cards.
Prepaid Visa Cards	Citizen Bank's target market for this product is primarily businesses who are interested in offering a card-based gift card program instead of a paper-based one. The business with the prepaid Visa program targets individuals to purchase the prepaid Visa like a gift certificate.

Mutual Funds

Citizens Bank, like its parent, Vancity, has partnered with Credential Financial Inc., a wealth management distribution company to the credit union system, to offer a limited selection of mutual funds to its members. Credential's mutual fund dealer arm, Credential Asset Management

provides back office infrastructure, mutual fund training and compliance registration and licensing, and mutual fund marketing support to licensed Member Service Specialists at Citizens Bank.

Through Credential, Citizens Bank's mutual fund offering includes 12 socially responsible Ethical Funds[®], and five funds under the Credential flagship, a money market fund, and four portfolio mutual funds. The Ethical Funds Company[™] was launched in 1992 and was the first mutual fund company to offer a family of socially responsible funds. While regular mutual funds evaluate investments primarily from a financial perspective, The Ethical Funds Company evaluates investments according to a triple bottom line, financial, social and environmental performance, and also promotes corporate accountability through shareholder action such as filing shareholder resolutions and proxy voting.

Each Credential portfolio encompasses eight to ten underlying Ethical Funds and third party funds which are weighted according to a particular investment profile based on the investment time horizon and the risk tolerance. The third party mutual funds include well-known brands such as AIM/Trimark, Franklin Templeton, and Fidelity Investments.

Discount Brokerage

Citizens Bank offers access to discount brokerage services of Credential Direct, also through the Credential partnership. With Credential Direct, members can set up self-directed accounts to invest in stocks, bonds, mutual funds, and a variety of other securities over the Internet or telephone.

RRSPS and RRIFs

Term deposits, mutual funds and discount brokerage services described are also available as part of an RRSP or RRIF either through Citizens Bank directly for term deposits, or through a Credential partner for mutual funds and discount brokerage.

Account Access

Retail members can access their accounts via online banking, 2,300 ATMs belonging to the EXCHANGE and Acculink networks, automated telephone banking, and through the telephone service centre which is staffed by live agents 24 hours per day, 7 days per week. The EXCHANGE and Acculink ATMs are usually found at credit unions as well as at HSBC and National Bank locations across Canada. While the cost of joining an existing ATM network reduces the initial investment and ongoing maintenance costs of a proprietary network for Citizens Bank, ATMs also provide a physical presence, albeit on a limited basis, for the bank's brand. Citizens Bank currently has one proprietary ATM at its Vancouver branch location and will be installing another proprietary ATM when the Calgary office moves to its new location in July of 2005.

1.4.2 Pricing

When Citizens Bank was launched in 1997, a key component of its positioning was that it offered higher deposit and lower borrowing rates than the big five banks (the other component being the first bank to offer an eight point ethical policy). Not surprisingly, in the annual member satisfaction survey commissioned by Citizens Bank, the top factor influencing members to start using Citizens Bank was the rates or fees, with 39% of those surveyed rates or fees first, and 77% ranking rates or fees within the top three factors⁴.

⁴ Citizens Bank 2004 Member Satisfaction Survey by CI Corporate Insights Inc.

Table 3 below illustrates pricing from three of the big five banks and also ING Direct and President's Choice Financial (PC Financial) compared to Citizens Bank for a selection of products.

Table 3: Selection of Citizens Bank Rates vs. Competitors

Product	Citizens Bank	ING	PC Financial	RBC	CIBC	BMO
Daily Interest Savings Account	2.45% ¹	2.40% ²	2.15% ³	0.05% ⁴	0.10% ⁵	2.00% ⁶
1 yr. Term deposit	2.70%	2.65%	1.785%	1.60%	1.60%	1.60%
Variable rate mortgage	3.50%	3.45%	3.50%	4.25%	3.88%	3.875%
3 yr. Fixed mortgage	4.60%	4.50%	4.50%	5.60%	5.60%	5.34%
5 yr. Fixed mortgage	4.80%	4.80%	4.68%	4.99%	6.05%	5.79%

Based on posted rates effective April 30, 2005

¹Citizens Bank Ultimate Savings Account

²ING Investment Savings Account

³PC Financial Interest First™ Savings Account

⁴Royal Bank Calculator Plus Account

⁵CIBC Premium Growth Account

⁶BMO Premium Rate Savings Account

1.4.3 Distribution Channels

Retail banking products and services are distributed either direct by Citizens Bank or through the intermediaries previously mentioned. Direct distribution by Citizens Bank is offered primarily by the National Contact Centre (NCC) and the two retail locations in Vancouver and Calgary.

Intermediaries include mortgage brokers, real estate agents, and Strategic Alliance partners.

1.4.3.1 Direct Distribution

1.4.3.1.1 National Contact Centre (NCC)

The NCC is a call centre with over 250 staff members comprised of six teams: Quality Monitoring, Performance (handles inbound calls), Workforce Management (scheduling and service assurance), Outbound Calls, Sales, and Interactive Voice Response (IVR) & Contact Centre

Analytics. The sales team provides account opening services and administration as well as lending services for personal loans, lines of credit and residential mortgages. The six teams report to the NCC Director, who in turn, reports to the Senior Vice President, Operations. Visa inquiries are handled by a separate Visa call centre.

When Citizens Bank launched in 1997, a dedicated call centre was set-up in addition to that of Vancity. In 2001, the Vancity and Citizens Bank call centres merged to create one expanded contact centre. Through a Service Level Agreement (SLA) with Vancity, the NCC handles Vancity calls in addition to those for Citizens Bank. As a result, the Member Service Specialists are universal agents, serving both Vancity and Citizens Bank clients. From a member standpoint, the consolidation of the two call centers is purely behind the scenes. Member still use separate phone numbers to contact Vancity and Citizens Bank and in the event a member has both a Vancity and Citizens Bank account, the member is referred or transferred to a different line for inquiries relating to the other account. Member Service Specialists are assigned to either a Vancity or Citizens Bank queue either for a portion or full period of their shift depending on total call volumes on the respective lines.

Through the merger, union representation of employees increased significantly from 36 employees in 2001 to 220 employees in 2005, approximately 86% of the total Citizens Bank workforce. These employees are represented by the British Columbia Government and Service Employees' Union (BCGEU).

The NCC is the bank's primary sales and service channel, providing service to the existing member base, and also handling fulfillment for leads generated through the telephone and the Citizens Bank website.

1.4.3.1.2 Retail Locations

Citizens Bank has two cashless retail locations in Vancouver, BC and Calgary, Alberta. The Vancouver retail office is located on the street level of the corporate head office at 815 W. Hastings. Each retail location handles account opening, term deposits, deposit taking services for cheques, foreign exchange for retail members, and general service inquiries. Mortgage and lending inquiries are directed to the NCC. The retail offices report to the Manager of Retail Operations, who reports to the Senior Vice President, Operations.

The Toronto office is a satellite corporate office and does not have a retail storefront to serve the general public.

1.4.3.2 Intermediaries

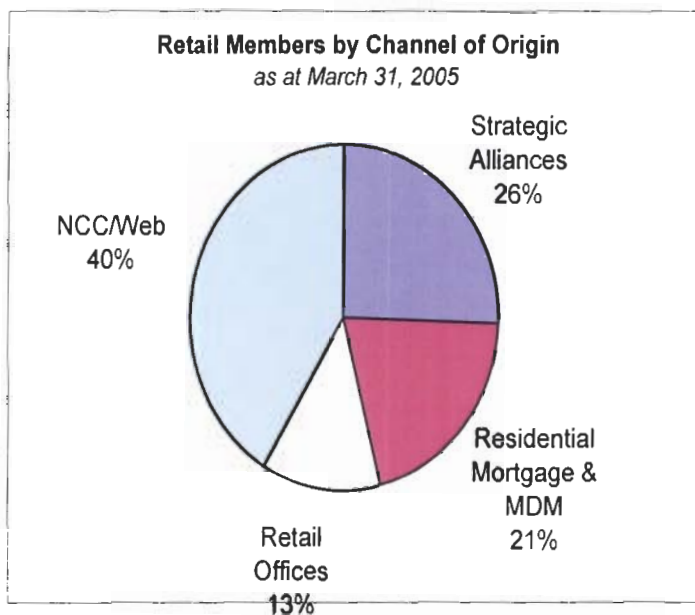
Retail members were acquired directly through the Bank's initial launch in 1997 which focused on the BC and Ontario markets and through the subsequent conversion of Citizens Trust clients to Citizens Bank in 2002. Outside of these circumstances, the primary form of retail member acquisition at the bank until late 2004 has been through third party intermediaries. On the credit or lending side, residential mortgages were acquired on a pay for referral basis through mortgage brokers, real estate agents, or direct to the consumer through a team of mobile Mortgage Development Managers (MDM) in the southern Ontario region. Mortgages originating from the mortgage broker channel are underwritten by the Residential Mortgages unit within the Vancouver head office. Personal loans were primarily acquired through strategic alliance partners, such as Homeworks for energy savings-focused renovations, and B3Dental, a provider of business solutions to the Canadian dental industry, for a patient financing program. RRSP loans were acquired through partners Odium Brown, a BC-based full-service investment firm, and E*Trade Canada, the Canadian arm of a US-based direct brokerage house. The intermediary-based channels attract members to the bank on the basis of price and convenience.

As for the source of deposits to fund these loans and mortgages acquired through intermediaries, Citizens Bank's deposit base is largely made of agent deposits, which account for roughly 85% of the bank's deposits. The Agent Services group provides deposits on a wholesale level to investment dealers and brokers who in turn offer the deposits to their own clients on a commission basis. Agent deposits typically have higher minimum investment amounts (\$5,000 or \$10,000 versus a \$500 minimum for retail deposits) and also offer a higher rate than the retail level.

1.4.3.2.1 Retail Members by Channel of Origin

The figure 1 below illustrates the channel of origin for retail members as of March 31, 2005.

Figure 1: Percentage of Retail Members by Channel of Origin



The bank's historical focus on intermediary channels is evident in the chart above, with 47% of retail members originating from either the mortgage broker or mobile Mortgage Development Manager channels. While acquisition through intermediaries is relatively cost-effective, the bank's overall presence in the marketplace and brand awareness is limited with such a strategy.

Of the remaining 53% of retail members who joined the bank through the NCC and retail offices, it is estimated that approximately 16% originated from the conversion of Citizens Trust. Even without the Citizens Trust clients, roughly 37% of retail members joined the bank directly. This can be attributed to a number of reasons. First, a successful member referral campaign which ran in the fall of 2004 added a number of retail members who joined primarily through the website and NCC. Furthermore, the bank's 2004 member satisfaction survey indicates that rates or fees, the Ethical Policy, and a referral from a friend or associate were the top factors ranked first by members as to which factors most influenced them to begin using the bank.

1.5 Target Market

1.5.1 Current Retail Membership Base

1.5.1.1 Demographics

Seventy-four percent of the bank's current retail member base is between the ages of 19 and 54, with 54% of retail members in the 35-54 age bracket alone. In terms of geographic location, 50% are in BC, and 35% are from Ontario, which is representative of the markets of the bank's original launch as well as a stronger presence in BC due to the location of its corporate headquarters and retail office. In terms of years of tenure with the bank, the member base is more evenly distributed with 28% having been with the bank for 12 months or less, 29% for one to three years, 18% for three to six years, and 24% for six years or more.

From the 2004 member satisfaction survey of 426 members (weighted to reflect by channel of origin), 69% of respondents are married or living in a common-law relationship and approximately three quarters are homeowners. Median household income was estimated to be approximately \$74,000 which is well above the Canadian median of \$46,752 (Statistics Canada 2000). Mean income is estimated to be \$85,000, which is relatively consistent with the surveys conducted over

the past three years, and again is above the Canadian mean income of \$58,360 (Statistics Canada 2000).

1.5.1.2 Share of Wallet

In line with member surveys conducted over the past three years, the 2004 survey revealed that over 90% of respondents use multiple financial institutions to meet all of their banking, borrowing and investment needs. These other financial institutions cited include the big five banks as well as ING Direct. Twenty-three percent of respondents would consider consolidating all of some of their financial business with Citizens Bank but over 53% indicated that they would not consider consolidation due to perceived lack of convenience in terms of branch locations and ATM coverage. An equally popular explanation behind the disinclination around consolidation was satisfaction with respondents' current banking arrangements.

1.5.2 Consumer Trends in Retail Banking

1.5.2.1 Banking Access

Customers are increasingly choosing self-service banking options as evidenced by a 2003 survey by the Bank for International Settlements (BIS) which found Canadians to be the top debit card and ATM users worldwide⁵. With the high internet penetration rate of Canadians with Internet access (78%⁶), online banking has experienced rapid growth over the past few years. A 2004 Canadian Bankers Association technology survey found the percentage of Canadians who bank primarily through the Internet tripled from eight percent in 2000 to 23 percent in 2004⁷. Despite gains in online banking usage, and decreases in the number of teller transactions, the May 2004

⁵ Taking a Closer Look: Ways Canadians Bank, Canadian Bankers Association, July 2004

⁶ The Canadian Inter@ctive Reid Report Fact Guide, Ipsos-Reid, March 2005

⁷ Technology and Banking: a Survey of Canadian Attitudes, Canadian Bankers Association, April 2004

Ipsos-Reid Canadian Financial Monitor found that ATM and tellers remained the primary banking transaction channels with 68% of Canadians still using in-branch teller service⁸.

1.5.2.2 Savings and Credit Habits

With record low interest rates over the past few years, Canadian have taken advantage of relatively inexpensive credit to finance big ticket purchases (e.g., vehicles, homes) as well as retail spending. In 2003, market researcher Millward Brown Goldfarb found the number of Canadians with a credit card at an all-time high and those the number of Canadians taking out a line of credit has also increased without an apparent reduction in those taking out personal loans⁹.

This debt accumulation has largely been fuelled by strong spending levels with little growth in personal disposable income levels. According to TD Economics, while real personal disposable income posted an average gain of 1.8 percent from 1989 to 2005, consumer spending grew at a faster average pace of 2.6%. To compensate for this imbalance, the personal savings rate has declined almost steadily from double-digit rates in the early 1990's to zero in the third quarter of 2004¹⁰. TD also notes that this decline in the savings rate coincides with personal debt levels reaching the all time high of 113 percent of personal disposable (after tax) income during the same period. Despite such trends, TD contends that warnings of a looming consumer debit crisis are overly cautious since the share of personal income attributed to debt servicing costs was the lowest on record in 2004, and secondly, the growth in household assets has more than offset rising debt levels.

⁸ Canadian Financial Monitor: Financial Services Channel Usage in Canada, May 2004

⁹ Consumer TrendZ 2003 – Volume 2: Financial Tools and Institutions, Millward Brown Goldfarb

¹⁰ Canadian Consumers to Keep Spending But Slow Their Pace of Debt Accumulation say TD Economists, TD Consumer Pulse, TD Economics, February 14, 2005.

Switching Activity Limited (Primary Financial Institutions)

The 2003 consumer trends report by Goldfarb found that 69%, or a vast majority, of Canadians had not switched main financial institutions in the preceding five years, with 22% indicating they had switched only once. Such figures are likely due to increased inconvenience of switching primary institutions with pre-authorized bill payments and direct payroll deposits. Other potential reasons are that consumers are reasonably satisfied with their primary institution for the most part, and given that on average in 2003, consumers held accounts with 4.4 banks¹¹, consumers are also comfortable with seeking an alternative financial services provider on a per product and service basis and do not necessarily see a need in switching their primary institution at the same time.

Wealth Management Trends

The mid to late 90's saw tremendous growth in the mutual fund and direct investing sector, which had slowed down considerably with the market downturn in 2000 and proliferation of product and service offerings in the marketplace. By 2003, Goldfarb found an increasing percentage of Canadians were delegating investment management to others, with 22% of investors saying that they delegate all of their investment management, and an additional 25% indicating that they delegate at least some of the management of their investments to third parties such as a financial planner or investment counselor.

1.5.3 Target Market

Citizens Bank's target market is defined as the online banking segment profiled below:

Online banking consumer profile:

- Primary target: Age 25 - 44, 45% of the total online market
- Secondary target: Age 55+
- Household income 60,000 to 99,000
- Well educated, but switching increases with education
- Age 25 - 35 greatest propensity to switch Financial Institutions (FI)

¹¹ Ipsos-Reid Core Tracking of Online Users, Q2 2004.

- Slight male skew
- Rate sensitive, Value conscious
- Tech savvy, internet savvy, broadband access
- Active in managing their money. Online banking attracts high quality, higher income clients who require less hand-holding.
- Have higher balances
- Buy more products
- Already purchasing on the web
- More loyal to their FI overall
- Time starved,
- 62.9% bank online more than once per week, 41.6% more than 2 times per week

With respect to insights about how this target market views financial institutions and hopes, aspirations, and fears, the following is an excerpt from the Citizens Bank brand blueprint developed in February 2005:

“Strivers” looking to get ahead, skeptical of the promises, generic dreams and vagaries put forward by the big banks; pragmatic when it comes to FIs – what can you do for *me*?; take a hands on interest in their own financial well-being; open to new FIs in their portfolio; inquisitive; confident in their ability to recognize true value; comfortable without the traditional branch banking safety net¹².

1.6 Product Revenues and Profitability

The bank earns revenues in two primary ways: 1) interest income or financial margin resulting from the spread between borrowing and deposit rates; and 2) non-interest or “other income” which includes revenues from sources other than financial margin.

Total interest income (retail and commercial) accounted for the bulk of the bank’s revenues (83.3%) in 2004. Residential mortgages and consumer loans make up approximately 73% of the assets on the bank’s balance sheet (before taking the allowance for loan losses into account).

Other income which accounted for roughly only 17.7% of revenue in 2004 and can be further broken down into the following member service fees, foreign exchange revenues, loan

¹² Citizens Bank Brand Blueprint, March 2005

administration fees, revenues arising from any service level agreements with Vancity, and mutual fund trailer fees, and any wealth management-related revenue sharing through Credential.

Gross margin for a variety of retail products can be found in the table 4 below.

Table 4: Selected Retail Product Revenues

Product	Gross Margin (bps)
Personal Loans	335 bps
Lines of Credit	195 bps
Mortgages	100 bps

*includes chequing and savings

Although residential mortgages account for the bulk of the bank's assets, they also yield the lowest spread. Shrinking margins in the residential mortgage product category over the past few years have arisen from both a continuing intense competitive environment, and more expensive sources of funding as the growth rate of retail assets far exceeding that of retail deposits. With record low interest rates fuelling the housing market, competitors have been clamouring for a piece of the mortgage business.

Visa is run as a separate division serving both Citizens Bank and Vancity. The subject of Visa-related revenues (e.g., fee and interest income), arising from any Citizens Bank Visa cards from Visa are currently under discussion between Visa and Citizens Bank. Currently, the only revenue Citizens Bank receives from Visa results from any after-hours calls that are handled by the NCC instead of Visa's call centre.

On the wealth management side, Citizens Bank receives proceeds from sales fees or mutual funds as well as quarterly trailer fee revenue on funds under administration. Such income is limited as mutual funds and wealth management have had little emphasis at Citizens Bank.

2 INDUSTRY ANALYSIS

Within the retail banking arena, Citizens Bank's narrow competitive set includes other virtual or non-traditional banks such as ING Direct, PC Financial, and relative newcomer, ICICI Bank while a broader definition of its competitive set includes traditional players such as the big five banks which include RBC Financial Group, TD Canada Trust, BMO Bank of Montreal, Canadian Imperial Bank of Commerce, and Bank of Nova Scotia, as well as credit unions, mortgage brokers, mutual fund companies, credit card companies, finance companies, and also trust and insurance companies depending on the product category.

2.1.1 Porter's Five Factor Analysis

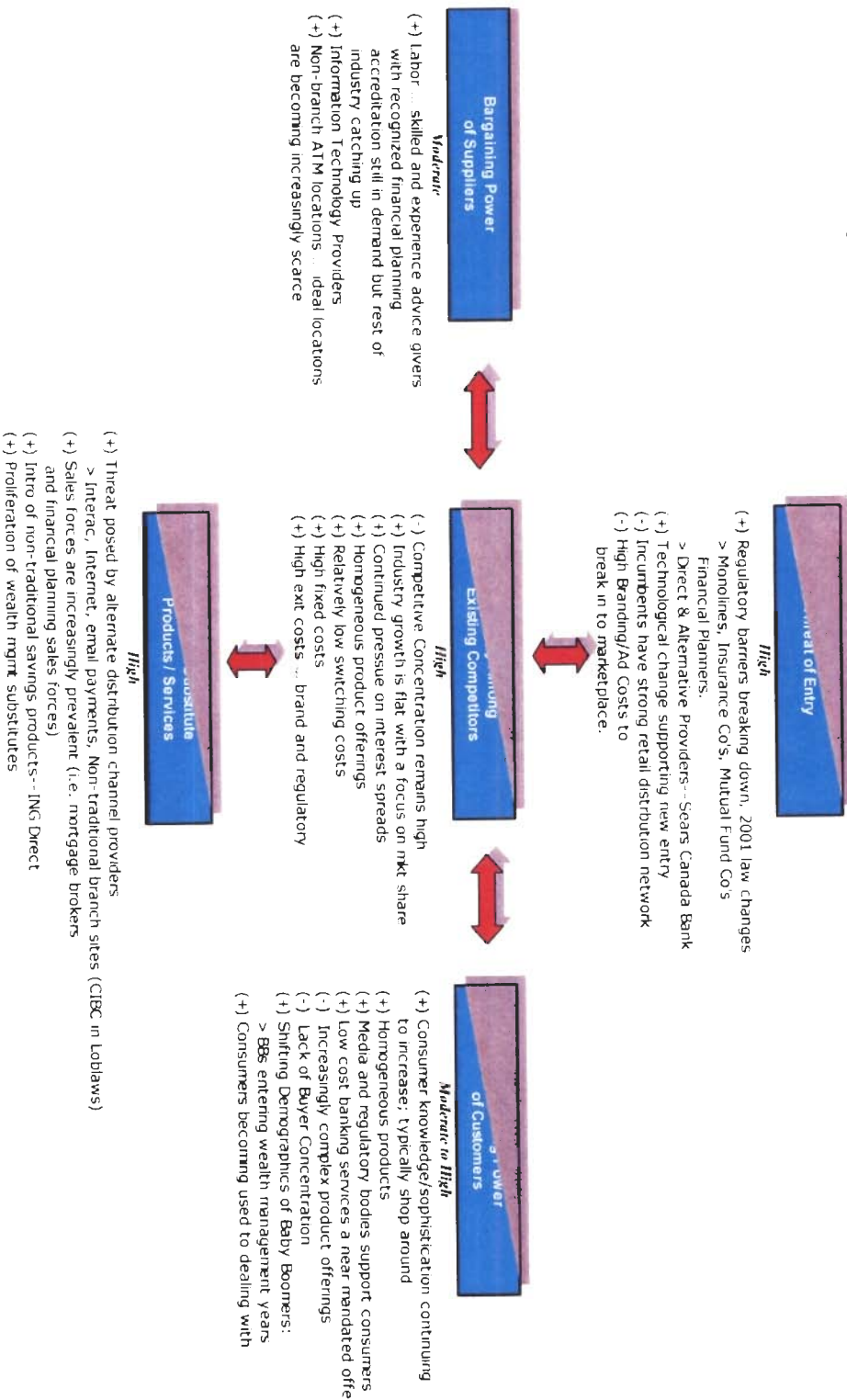
Porter's Five Factor analysis is detailed in figure 2.

2.1.1.1 Rivalry Among Existing Competitors

Retail banking in Canada is a mature industry with relatively flat growth. The growth in the earnings of Canada's top banks illustrated in Figure 3 is largely due to cost cutting and consolidation efforts, an increasing portion of income coming from foreign sources with Canadian banks deriving approximately 33 percent of their revenues from outside the country in June 2004¹³, and increased contribution from non-interest income.

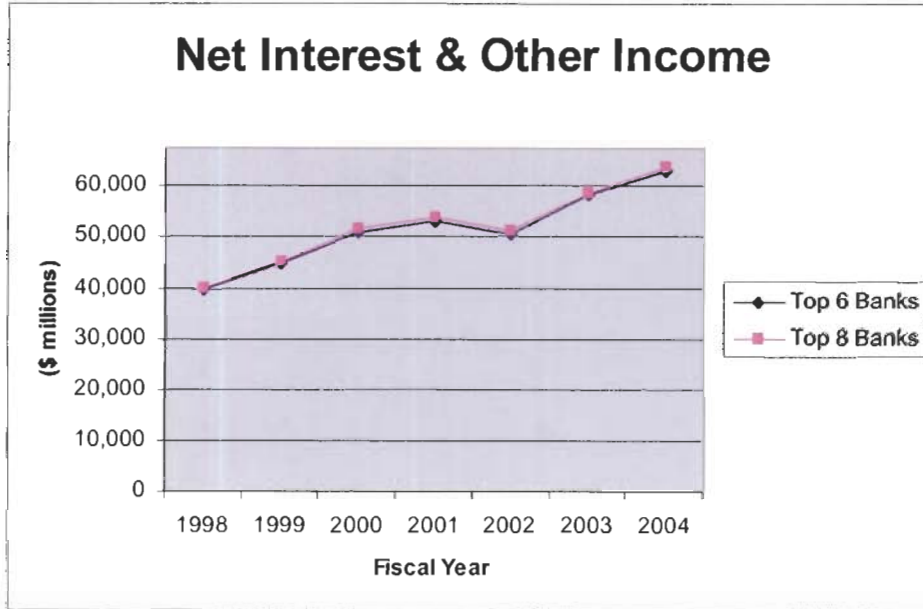
¹³ Taking a Closer Look: Bank revenues and earnings (profits), Canadian Bankers Association, June 2004

Figure 2: Five Factor Analysis: Canadian Retail Banking Industry



Adapted from Bukaszar Class Notes 2005 & Porter 1979

Figure 3: Net Interest & Other Income for Canada's Top 8 Banks, fiscal 1998-2004



Top 8 banks include: BMO Financial Group, Canadian Western Bank, CIBC, Laurentian Bank of Canada, National Bank of Canada, RBC Financial Group, Scotiabank, TD Bank Financial Group.

Top 6 banks include: BMO Financial Group, CIBC, National Bank of Canada, RBC Financial Group, Scotiabank, TD Bank Financial Group.

Data: Canadian Bankers Association DB 251, Database of Domestic Banks' Financial Results.

Royal, TD, and BMO have continued their US expansion plans, while Scotia has focused on its Mexican retail banking operations. Another factor bolstering bank earnings over the past few years is the strong demand for credit fuelled by low interest rates which will not last indefinitely.

Slow or little organic growth has intensified overall competition and this factor coupled with overcapacity and homogeneous products, have led to a battle for market share among industry players. As a result, increased competition from new entrants as well as the amongst the incumbent banks means that pressures on profits are unlikely to subside. According to a 2005

PriceWaterhouseCoopers report on the Canadian banking industry, "it is extremely difficult to consistently outperform your competitors over a long period of time in retail banking. Customer services initiatives or new products can be easily replicated so there is not such thing as a sustainable, unique product"¹⁴.

Increased competition, particularly from lower-cost players such as virtual banks or monoline providers, yields additional pressure on interest rate spreads in Canada, which are already among the lowest in the Organization for Economic Co-operation and Development (OECD) countries¹⁵. In 2002, Canadian interest spreads were more than a full percentage point lower than in the United States. Net interest income (the difference between a bank's lending and deposit rates) has historically been the banks' main source of revenue. Non-interest income derived from wealth management, securities trading commission, securities underwriting, foreign exchange, and other services has been increasing over the past decade and now accounts for 51% of bank revenues¹⁶.

Due to the previously high regulatory barriers, competitive concentration within the broader financial services industry remains high with the top five banks accounting for 85% of assets¹⁷. While this concentration may reduce rivalry overall in the industry, competition is still intense between these major players and can be particularly intense on a per product line basis (i.e., residential mortgages).

High fixed costs in technology and infrastructure and high exit costs both contribute to increased rivalry. The financial services industry relies heavily on technology, as evidenced by the \$25 billion invested in technology by the nation's six largest domestic banks (top five including

¹⁴ Canadian Banks 2005, Perspectives on the Canadian banking industry, PriceWaterhouseCoopers, accessed at [http://www.pwcglobal.com/extweb/ncsurvres.nsf/0cc1191c627d157d8525650600609c03/30bc115014aeda6085256d6b004d2311/\\$FILE/cb_2005a.pdf](http://www.pwcglobal.com/extweb/ncsurvres.nsf/0cc1191c627d157d8525650600609c03/30bc115014aeda6085256d6b004d2311/$FILE/cb_2005a.pdf), May 6, 2005.

¹⁵ World Economic Forum 2003-2004 Global Competitiveness Report

¹⁶ Canadian Bankers Association, Bank Revenues and Earnings, June 2004

¹⁷ Department of Finance, August 2002. Top five banks include: Royal Bank, CIBC, TD CanadaTrust, Bank of Nova Scotia, and Bank of Montreal.

National Bank) since 1996. Technology investments and a sound banking system in Canada have led to the highest penetration worldwide in the usage of electronic channels such as debit cards, Internet banking, and telephone banking¹⁸.

Regulatory requirements placed on banks engaged in financial service consolidation and branch closures are burdensome. For example, banks are required by law to provide advance notice of branch closings—at least four months and in some cases six months—when planning branch closures. The Financial Consumer Agency of Canada (FCAC) maintains a database of branch closures across Canada that is accessible via its public website. Given the negative media around branch closures, banks also usually need to invest in resources in public relations around any branch rationalization plans.

Given industry dynamics, the consolidation trend in both domestic and global markets is likely to continue. In Canada, 185 mergers and acquisitions occurred in the financial sector from 1993 to 1996, up from 125 in the previous four years¹⁹. Mergers have also been a popular business strategy in the credit union sector. As of November 2004, there were 572 credit unions in the Canadian Central affiliated credit union system, a drop from 732 credit unions in 2000²⁰. Despite the two failed merger attempts by BMO & RBC and CIBC & TD in 1998, a successful merger between TD and Canada Trust in 1999 demonstrated that large scale bank mergers can work when provisions addressing any lessening or prevention of competition are included in the ruling of the Competition Bureau. 2001 changes to banking legislation included a formal review process for mergers involving banks with shareholder equity over \$5 billion. Despite these legislative changes, the federal government has been relatively quiet on the issue of bank mergers since the TD Canada Trust union.

¹⁸ Ways Canadians Bank, Canadian Bankers Association, July 2004

¹⁹ Text from Legislative Summary for Bill C-8, www.parl.gc.ca/common/bills_ls.asp?Parl=37&Ses=1&ls=c8, accessed Feb. 12, 2005

²⁰ Credit Union Central of Canada Submission to the House of Commons Standing Committee on Finance, November 2004

2.1.1.2 Threat of Entry: HIGH

Canadian banks are regulated federally under the Bank Act while activities of bank subsidiaries such as securities and trustee services are provincially regulated. Regulatory barriers in the financial services sector have been eroding over the last 15 years, effectively blurring the traditional four pillars separating banks, trust companies, securities dealers and insurance companies. Following a review of banking legislation by Task Force on the Future of Financial Services Sector in the late 1990's and 2000, the federal government introduced significant regulatory reforms promoting increased domestic competition through Bill C-8, which took effect in October 2001. Highlights of the 2001 legislation include:

- **Introduction of a formal bank merger review process.** The banking industry interpreted this move as a signal that the federal government viewed bank mergers as a legitimate business strategy in the face of globalization and industry consolidation.
- **Holding company structure** which gives banks flexibility in separating divisions not related to retail deposit-taking and insurance to benefit from a lighter regulatory burden in these areas. This also allowed foreign banks already in Canada to expand their service offerings.
- **Changes to ownership rules** which increased the limit a single shareholder could own, and a tiered ownership structure which effectively permitted commercial ownership of banks. This resulted in the introduction of Canadian Tire's banking subsidiary, Canadian Tire Financial Services and Sears Canada Bank, whose Sears Card represents the single largest card franchise in Canada. Western Financial, a network of British Columbia and Alberta-based insurance agencies, launched Bank West offering deposits and personal and commercial lending in January 2003.
- The ability for credit unions to create a national service entity to give the fragmented movement a national presence.

- **Expanding access to the payment system to non-deposit taking institutions** which allowed money market mutual funds, insurance companies, and securities dealers to join the payment system which gave them the ability to offer services such as deposit accounts and debit cards, areas previously limited to only banks.
- **Establishment of the Financial Consumer Agency of Canada (FCAC)** to enforce consumer-related provisions of the legislation, monitor the industry's self-regulatory codes and be involved in consumer education.

Canadian banking legislation is subject to review every five years with the next review due in 2006. This legislated five-year review provision ensures that the regulatory framework remains current and is sufficiently flexible for the financial service industry to react to the changing market environment.

Even prior to the 2001 legislative changes, foreign competitors such as MBNA, a US credit card company and ING Direct, the direct banking franchise of Dutch parent company ING, both entered the Canadian market in 1997 offering a single or select product suite. Eight years later, MBNA is the second largest Mastercard issuer in Canada²¹ and ING Direct has attracted 1 million Canadian customers and over \$14 billion in total assets²². Insurance company, Manulife, started up Manulife Bank of Canada, a virtual bank, for which services are distributed through their extensive advisor and broker network. New discount brokers to the market in the early 2000's include eNorthern, QTrade and Credential Direct.

The high branding or advertising investment required to enter the market generally detracts from the threat of entry, particularly without an extensive retail distribution network providing a physical brand presence. The incumbent banks have invested significant sums in brand building over the past few decades. Brand Finance, a consultancy focused on brand management and valuation based in the UK, found Royal Canada to be Canada's most valuable brand as of November

²¹ MBNA Canada web site, http://www.mbna.com/canada/about_canada.html, accessed Feb. 12, 2005

²² ING Direct website, <http://www.ingdirect.ca/en/whoweare.html>, accessed Feb. 12, 2005

2004²³. Six of the top ten Canadian brands listed by Brand Finance are either banks or insurance companies. Newer entrants have addressed this area in by either investing heavily in mass media advertising to establish presence (ING Direct) or by partnering with established brand names, such as President's Choice Financial (PC Financial) or MBNA's affinity strategy of tying their various Mastercard offerings with recognized Canadian associations or educational institutions for a co-branded offering. Sears and Canadian Tire launched financial service offerings bearing their established brand names.

Bricks and mortar or the extensive retail branch network of incumbents can be viewed as a threat to entry both from the perspective of fixed cost investment and also the scarcity of prime locations. However, new entrants benefit from a second mover advantage by leveraging technology, specifically the Internet, to minimize the need for a widely available retail presence and lower their costs of entry. In addition, newer entrants have tended to offer a limited (and thus lower cost) physical presence such as through ING's kiosk/sales office locations in four key locations across Canada, while PC Financial has located its pavilions in Loblaw's or Real Canadian Superstore supermarket locations throughout the country. The cost of entry is significantly lower for virtual banks. For example, CIBC estimates that the average pavilion costs only one-fifth as much to operate as a traditional branch²⁴.

Innovation in technology and product design also supports the ease of entry beyond counteracting the existing retail network. Banking with ING actually requires you to maintain your chequing account at your primary financial institution. That's because ING has created a "sweep" feature that facilitates easy electronic transfers between ING and the third-party financial institution via the web or phone. As an example, when accountholders want to withdraw from the ING account, they simply transfer the funds back to their primary institution and withdraw in the form of cash through a branch or ATM, cheque, bank draft or wire transfer. The cost and front and

²³ Measuring and Valuing Brands, including Canada's Most Valuable Brands, prepared by Brand Finance and the Institute of Communications and Advertising, November 2004

²⁴ Case Study: CIBC's Amicus Strategy—Leveraging Brand Alliances and Low cost Distribution to Build Market Share, TowerGroup, March 2001

back-office infrastructure required to offer deposit and withdrawal means are left with the primary institution while all along, ING holds the deposits by offering clients a significantly higher rate of interest than the traditional banks. By exploiting the expensive infrastructure already in place through their product/service design, ING is able to achieve significant cost efficiencies over traditional banks. ING does not offer chequing accounts and only has a very limited branded ATM network for small withdrawal amounts only. PC Financial is backed by CIBC's Amicus arm, which allows PC Financial to leverage CIBC's infrastructure such as their back office processing, ATM network, and systems.

2.1.1.3 Threat of Substitutes: HIGH

The threat of substitute products and services continues to grow with the entrance of monoline or select product suite players such as ING Direct, PC Financial, and MBNA, as well as increasing consumer usage of electronic channels that render the physical location of a branch far less important for regular banking needs. The success of ING's Investment Savings Account with over 1 million clients in only eight years is proof that the threat of substitute products is all too real. ING's non-traditional savings product which pays a rate comparable to short-term investment deposits is displacing savings accounts, short term investment certificates, and potentially even money market mutual funds. No fee chequing accounts are available from relative newcomer PC Financial, or even incumbents such as Coast Capital Savings Credit Union, which recently launched the first no-fee chequing account from a full services financial institution in Canada in January 2005.

On the payments front, Canadians are the world's top debit card users with the Interac direct payment service offered by more than 365,000 retailers across Canada and most banks offering a form of email money transfer to third parties at other financial institutions. Payment services such as Paypal also provide another email-based payment option, particularly for online auctions. Toronto-based start-up Dexit allows customers to load money from their bank account on to a

Radio Frequency Identification or RFID tag that allows consumers to pay for small value items like coffee or newspaper by waving the tag in front of an RFID reader at the retailer. Interestingly, the volume of ATM cash withdrawals declined approximately 5% in dollar terms during the period between 1998 and 2003²⁵. This downward trend is likely to continue as Canadians increasingly use direct debit and alternative electronic payment methods such as email money transfers or stored value payment services.

Substitutes for the loans and mortgages offered by banks have been abundant. Increased use of the mortgage broker channel by mortgage buyers demonstrates that consumers view mortgages like any other financial product, as a commodity, and that they have a high propensity to switch as they view competitive offerings as near perfect substitutes, provided that rates and primary terms are similar. On the loan side, banks regularly compete with the auto financing arms of automobile manufacturers such as Ford Credit. By using its flexible, high-rate and no fee savings account as an entry product to build brand recognition and a sizable client base, ING has been shifting its focus to cross-sell other asset-building products through its direct banking model, such as mortgages, lines of credit and mutual funds and continues its aggressive pricing stance on these offerings.

The financial services industry as a whole has been placing increased emphasis on wealth management as the aging baby boomer segment shifts from its borrowing to savings years. Commoditization is widespread in the wealth management area as well with both bank-owned and independent brokerage (full service and discount) and financial planning or advisory firms. Banks are now selling third party or non-bank mutual funds at the branch level, a product offering that was traditionally only available from the brokerage level and above or direct from selected mutual fund companies. There is a trend towards to managed asset products, or wrap mutual fund programs that package the commodity component, mutual fund portfolios, with advice and ongoing monitoring from third party experts, Mercer Investment Consulting or SEI Investments.

²⁵ Canadian Bankers Association, Ways Canadians Bank, July 2004

Such advice is typically only available at the discretionary (\$250K to \$500K+ per account) or institutional account sizes but wrap programs provide access to account holders with lower minimums of \$10K or \$25K. Due to product development in this area, wrap or managed asset programs are offered by almost all banks and mutual fund companies so many substitutes are readily available.

Overall, the threat of substitutes can be characterized as high. The pricing performance of substitutes is often superior from monoline providers, switching costs are relatively low, and buyers have a high propensity to substitute as they view competitive offerings as interchangeable commodities and become better educated and informed through self-research and the media.

2.1.1.4 Bargaining Power of Suppliers: MODERATE

The bargaining power of suppliers continues to be moderate. While the number of financial advisors with professional accreditations has been increasing, skilled and experienced advice providers continue to be in demand. Due to the IT-intensive nature of industry, banks also have a critical interdependency on IT suppliers and major players have signed IT sourcing agreements. In July 2004, TD Bank Financial Group announced a seven-year \$420-million deal with HP for HP to manage and upgrade its ATM and point-of-sale infrastructure while ING Canada has partnered with IBM and Scotia Bank has partnered with EDS²⁶.

While brick and mortar locations continue to provide retail presence, physical locations in demand now relate to ATMs in non-bank locations such as gas stations and supermarkets due to criteria such as customer convenience, 24-hour access, parking access, and the growing presence of private label ATMs. In addition, some ATMs are also being expanded to offer additional services such as foreign currency dispensing and passbook updates. The Fraser Institute found that the

²⁶ Banking on Technology by Benoit Courtois, Globe and Mail, October 27, 2004

number of big five bank branches shrank by 18.3% from 1990 to 2000 while the number of ATMs increased by slightly more than 100% to 16,192 during this same period²⁷. A cursory look at the FCAC database²⁸ of branch closures in Ontario, BC, and Alberta during 2002 to 2004 indicated that a substantial portion of affected branches belonged to TD Canada Trust, who engaged in both branch rationalization and divestiture in certain markets to address competition bureau concerns.

2.1.1.5 Bargaining Power of Customers: MODERATE TO HIGH

Customer bargaining power is moderate to high overall due to the homogenous nature of the products and low switching costs, and the relative ease of comparing competitive offerings despite the lack of buyer concentration. These industry characteristics coupled with popular media calling for consumers to take charge of their financial future instead of relying on the government programs like the Canada Pension Plan and a growing level of customer knowledge in the Internet age have generally led to a more sophisticated and savvy financial services consumer. Customers typically shop around for the best deal and negotiate investment deposit and mortgage rates. With the power shifting to consumers and the emergence of monoline providers, customers are increasingly dealing with multiple financial institutions rather than a sole primary financial institution for all of their financial needs. This shift in customer behaviour is evident in the fact that customers held accounts at 4.4 financial institutions in 2003²⁹ and the previously mentioned information from Statistics Canada which revealed that only 23% of household financial assets are held with banks.

Shifting demographics also contribute to the bargaining power of customers. Banks and other financial service are vying to win the business of the Baby Boomers with sizable retirement assets

²⁷Financial Services Reform is Politicized and Dated, Fraser Forum (The Fraser Institute), July 2001, http://oldfraser.lexi.net/publications/forum/2001/07/section_07.html, accessed Feb. 14, 2005

²⁸ Financial Consumer Agency of Canada, branch closure tool: www.fcac-acfc.gc.ca/eng/consumers/branchclosures/BranchClosures_e.asp, accessed Feb. 14, 2005

²⁹ Ipsos-Reid Core Tracking of Online Users, Q2 2004

and often more complex financial needs. This eagerly anticipated market need has led to banks beefing up their wealth management arms with expanded services in the areas of financial planning, tax planning, estate planning and discretionary investment management over the last decade. While financial institutions are catering to these more complex needs, product and service complexity is growing according and consumers are faced with more choices than ever before.

Most of the major banks have committed to providing low fee bank chequing account and banks cannot refuse customers that meet the account opening requirements unless they have reasonable grounds relating to fraud or crime. While bank-bashing peaked in the mid to late 90's, media and regulatory bodies continue to advocate on behalf of customers. As mentioned previously, the 2001 legislative changes created the Financial Consumer Agency of Canada, whose mandate is to protect and educate consumers of financial services by supervising and monitoring the compliance of financial institutions with consumer protection measures.

2.1.2 Industry Attractiveness

Overall industry attractiveness has been declining due to flat or no growth, lowering regulatory barriers, which encourage entry and substitution, fast consumer adoption of technological advances, overcapacity and narrowing spreads, convergence of banking, trust, insurance, and securities/wealth management, increased customer buying power, and the likelihood of continued consolidation as the industry continues to emphasize efficiency and cost reduction.

2.1.3 Key Success Factors

Given the competitive forces in the industry and current industry structure, key success factors in the retail banking industry are as follows:

- **Continued technological innovation** by both bank and non-bank players. Technology continues to be the backbone of the banking and broader financial services industry and electronic banking channels are well adopted by the Canadian public. As demonstrated by ING, smart use of technology, specifically the Internet, can neutralize some of the distribution network advantage held by industry incumbents.
- **Scale or the ability to exploit existing scale and infrastructure.** Due to the high fixed costs in the industry, new entrants either need to possess deep pockets or the ability to exploit the existing scale of incumbents through clever and innovative product design (i.e. ING's "sweep" feature which piggybacks on the existing infrastructure already in place) or partnerships and alliances (PC Financial partnering with CIBC's Amicus division for ATM networks and other infrastructure).
- **Branding/Reputation** through some level of physical locations (even if limited to key markets) or by building brand recognition through heavy mass media advertising to break into the market or by partnering with established brands as did PC Financial with President's Choice. Physical locations also serve to build credibility and provide a sense of security. Although switching costs are relatively low, brand positioning must be compelling enough to overcome the inconvenience of switching (note that inconvenience levels differ by product).
- **Focus on lower-cost and increased efficiency.** Given the flat industry growth, overcapacity and product homogeneity, differentiation is becoming more difficult and industry players will continue to compete on the basis price to steal share from rivals. Efficiencies and lower cost structures continue to be important given the strong likelihood of further consolidation.

3 INTERNAL ANALYSIS

3.1 Generic Strategy of Citizens Bank: Stuck in the Middle

Although Citizens Bank is not a credit union, Citizens Bank is rooted in the same credit union values as Vancity, which follows a clear differentiation strategy with its focus on social and community values and a triple bottom line (social, economic, and environmental). As a whole, credit unions differentiate themselves as being more member and service-oriented than the Big Banks. Citizens Bank was initially formed by Vancity to take its values beyond the borders of British Columbia and followed a clear differentiation strategy as the only bank in Canada with an Ethical Policy that states its position on key social and environmental issues. Moreover, in keeping with Vancity's track record of innovation in the banking industry, Citizens Bank was the first branchless bank in Canada when it launched in 1997, launching even before ING Direct.

The most cost effective way to expand beyond BC while leveraging Vancity's existing infrastructure and systems was to launch a branchless or virtual bank. As a result, one of Citizens' core business strategies is to leverage synergies with Vancity with respect to information systems, market/product research and development, human relations programs and information systems. Citizens will often piggyback the programs and efforts of Vancity in a number of these areas where appropriate.

In using corporate social responsibility and triple bottom line focus as a differentiator (with differentiator defined as a distinguishing factor that is relevant and compelling to the target market) within the marketplace, Citizens Bank follows a niche strategy in principle. As expected, slow but steady membership growth during the bank's short tenure has been consistent with such a strategy. In practice however, the bank's branchless banking model, and focus on intermediary channels in which transactions are driven primarily by price have somewhat worked against the

original differentiation strategy. These internal factors along with aggressive new entrants and industry dynamics have led the bank to lean more towards a low cost strategy without losing its differentiation-based heritage. The result: the bank's business strategy can be characterized as stuck in the middle between its differentiation roots, and the predominant business model of virtual banking competitors.

3.2 Strategic Fit

Strategic Fit Chart - Citizens Bank of Canada

Variables	Cost Based		Differentiation		
	Low Cost / Adequate Quality		High Quality / Adequate Cost		
	←—————→				
	Score: 1 2 3 4 5 6 7 8 9 10				
Product Strategy	Rapid Follower	←	☆	Innovative	
R&D Expenses	Low R&D		☆	High R&D	
Structure	Centralized	←	☆	Decentralized	
Decision Making	Less Autonomy		☆	Autonomy	
Manufacturing	Economies of Scale	←	☆	Economies of Scope / Flexible	
Labour	Mass Production		←	Highly Skilled / Flexible	
Marketing	Comparative Push		←	High Cost / Pioneering / Pull	
Risk Profile	Low-Risk	☆		High-Risk	
Capital Structure	Leveraged			☆	Conservative

Source: Adapted from Bukszar Class Notes, 2005

3.2.1 Product Strategy

As described in the first section Citizens' current product line-up offers a reasonable selection rather than a breadth of retail financial products and services covering the basic product categories of everyday banking (bank accounts and plans), four to five residential mortgage products, a personal loan, line of credit and RRSP and RRIF term products. Due to the primary focus on streamlining the bank's operations during 2001 to 2004, the first new product since the bank's inception, a high interest savings account, was launched in spring of 2005. This high interest savings account was modeled after a similar product from a direct competitor. A key area lacking sufficient representation in the bank's product line-up is in the area of wealth

management, specifically a broader mutual fund offering, and other investment products. The lack of product breadth results in competition based on costs.

Vancity, on the other hand, offers a broader selection of financial products covering all of the previously described areas as well as others. In addition, innovation is key component of Vancity's corporate mission, with product innovation typically rooted in its deeply-held values of Corporate Social Responsibility (CSR) and member engagement. Vancity's firsts within B.C. include launching Canada's first socially responsible mutual fund (the Ethical Growth Fund[®]), offering Canada's first daily interest savings account, offering mortgages to women without a male co-signor, the first international ATM network, and the first Registered Education Savings Plan (RESP).

Due to the significant investment required to launch new products that include systems configuration, market research, and training expenses, Citizens Bank plans to either re-brand or modify existing Vancity retail products to benefit from economies of scope and/or emulate successful competitive products to lower the cost of product development.

3.2.2 Research and Development (R&D)

R&D efforts in the financial services industry revolve around employee training and programs, current and future customer needs, as well as technology.

A keen focus on people and employee engagement are part of the Vancity group's stated values and commitments. The Vancity group has consistently been recognized as one of the Top 100 Employers in Canada and was named Canada's Top Employer by *MacLean's* magazine in 2004. These values are also held deeply within Citizens Bank, with the underlying belief that employees who are engaged and more committed will better serve its customers, which in turn, benefits the bank. Employee engagement is a key performance indicator and is measured on an annual

basis through an Employee Engagement Index (EEI) within the bank. Employee feedback is gathered both formally through an annual employee survey administered through a third party research firm and also through informal employees focus groups facilitated by the Human Relations department.

For the most part, employee programs such as flexible benefits, flexible work schedules and allowances for tuition reimbursement tend to mirror what is offered by Vancity. Employees can view available internal courses, third party web links, and create a customized development program through an online learning portal called DiscoverU which is jointly available to both Vancity and Citizens Bank employees. For more specific types of training, such as third party sales training, Citizens Bank will again piggyback the efforts of Vancity, allowing Vancity to spend resource time investigating potential options and vendors and setting up the program.

With respect to monitoring the needs and satisfaction of current members, member feedback gathered both through regular member interactions and a comprehensive annual member survey form the basis for action plans and programs to increase member satisfaction. Member satisfaction targets are part of the bank's annual overall performance targets, and also play a role in employee performance plans.

As for research around the future needs of customers, changes in buying behaviour, and advertising response, Citizens Bank generally seeks to minimize any R&D expenses in these areas by leveraging applicable primary research conducted by Vancity (which has a market research team of four to five individuals), gaining access to any secondary research studies purchased by Vancity, or selectively purchasing secondary research directly. For strategic initiatives and/or initiatives requiring significant investment, Citizens Bank will conduct limited primary research. In terms of product and/or service development, Citizens Bank typically either follows Vancity's efforts where applicable by modifying an existing or soon to be launched Vancity product, or will emulate popular competitive products which fit with the bank's overall strategy.

On the technology front, Citizens Bank again follows the lead of the parent company, timing the upgrades its enterprise systems (e.g. banking platform, CRM) to coincide with Vancity to get the most value while limiting its own investment. The bank also relies on affiliated partners such as CUCBC which provides its web banking and payment processing infrastructure, to handle related R&D and supply competitive offerings.

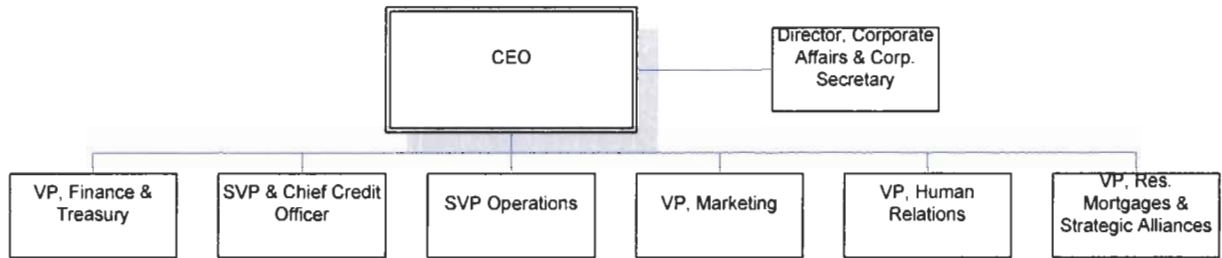
Overall, the level of R&D at Citizens Bank can be characterized as low, largely due to its ability to leverage the efforts of its parent company. A low level of R&D usually fits best with a low cost rather than differentiation strategy.

3.2.3 Organizational Structure

The organizational structure of Citizens Bank is largely centralized with nearly 60% of its workforce belonging to the bank's call centre, albeit this figure is comprised not only of front line staff but also team leaders, managers, and support staff in the areas of workforce management and quality monitoring.

Citizens Bank is organized according to traditional functional areas for a bank, Finance & Treasury, Credit, Operations, Marketing, Human Relations, along with a Residential Mortgages & Strategic Alliances division as illustrated in Figure 4 below. The NCC, with its 257 staff members, reports to the SVP Operations. Centralization is aligned with a low cost strategy.

Figure 4: Organizational Chart – Executive Level



3.2.4 Decision Making

Citizens Bank’s collaborative culture and focus on stakeholder engagement also extends to the internal stakeholder groups within the decision making process. The engagement of various functional areas tends to result in lower levels of autonomy because decision making is often vetted through various committees prior to final approval. In addition, internal stakeholder groups can sometimes include counterparts within the Vancity parent company. As a result, decision making typically requires added time and coordination in providing sufficient opportunity for various internal stakeholder groups and cross-functional committees to weigh in on important decisions and issues. Less autonomy in decision making due to the engagement of multiple stakeholders detracts from the strategic fit with the overall differentiation strategy as this slows down decisions and reduces the responsiveness of the organization to change. Should lower autonomy levels rather result from more centralized decision making, this decision making style would be more in line with a low-cost strategy.

3.2.5 Manufacturing

The “production” of financial services involves both economies of scale and scope. The inputs required (system-related investments, premises, distribution channels, staff training) are common

across the various financial products and services offered. However, given the fixed cost nature of most of the inputs, scale will mean that average costs are lowered as volume increases. For example, the administration, processing, and background support required to sell a \$500,000 mortgage are largely identical to the requirements for a mortgage one-fifth the size. The balance between both scale and scope may impede the ideal level of flexibility required for a differentiation strategy.

3.2.6 Labour

Strategic fit for the labour variable leans toward skilled labour at Citizens Bank, particularly in front line areas where financial needs may be more complex than general front line transactions and inquiries. These include lending, and also investment planning and mutual fund sales. Skilled labour in technical roles also exists in head office functions such as Treasury, Credit, Marketing, Operational Excellence, Human Relations, and Corporate Social Responsibility. At Citizens, where the primary retail servicing channel is the call centre serving both Citizens and Vancity, agents cross-trained in a variety of product and service areas for both companies provide added flexibility as a shared resource pool. Accounting for nearly 60% of the bank's employees, the call centre enables both specialization and scale. Despite the tendency towards more rather than less skilled labour, the bank's total labour pool is small relative to traditional banks. Skilled and flexible labour supports Citizens' overall differentiation strategy in terms of delivering high service levels.

3.2.7 Marketing

Citizens Bank has traditionally used push marketing through its historical focus on third party intermediary channels, mortgage brokers and realtors, strategic alliance partners, and Agent Deposit investment dealers. With its five year strategic plan, the bank is looking to adopt more pull marketing practices as part of its plan to establish a stronger retail presence in the financial

services marketplace. The longer term outlook is to lower acquisition costs through direct retail channels compared to intermediaries; however such a strategy will require significant investment in brand building and awareness. Pull marketing initiatives would drive leads to proprietary distribution or lead management channels: website, call centre, or retail offices, which is aligned conceptually with a differentiation strategy. On the other hand, these pull marketing initiatives have featured a comparative pricing element in its messaging, which is traditionally associated with a low cost strategy. Given the bank's target market, financially savvy Internet bankers who are comfortable without a branch network, and the fact that it is relatively unknown branchless bank, advertising and promotions have been rate focused more recently.

3.2.8 Risk Profile

Citizens Bank's overall risk profile can be considered relatively low, given that its original strategy has partly been an extension of Vancity's values-based approach. From a systems and infrastructure perspective, joint systems and development between Citizens and Vancity means that Citizens can benefit from more comprehensive systems at usually a fraction of the initial investment and ongoing maintenance costs. On the process side, the bank has formally documented policies and procedures for customer requests from ordering a bank card to opening an account. The bank has a Risk Management Committee comprised of individuals from Treasury, Finance, IT, Credit Risk, and CSR, which approves material changes to policies and procedures. In addition, as a bank, Citizens Bank operates in a highly regulated industry governed by the federal Bank Act and must file regular reporting (capital and liquidity requirements) with the appropriate regulatory bodies.

3.2.9 Capital Structure

Citizens Bank's capital structure can be assessed as relatively low risk which contributes to strategic fit with a differentiation strategy. In 2004, the bank's debt equity ratio total debt

(calculated as long-term debt over common equity) was 16.3%. The bank's only long term debt consists of a subordinated debenture issued in 2001 to its parent company, Vancity. In terms of the debt to total capital ratio, (calculated as short term plus long debt divided by the sum of liabilities and equity), the bank's ratio (excluding any deposit-related liabilities) is 41.5%, which indicates a relatively low level of leverage. Vancity owns 100% of the bank's share capital.

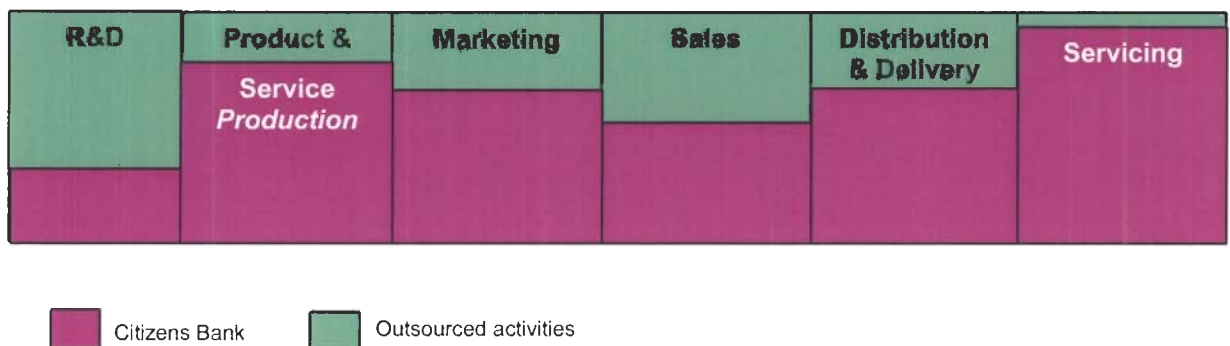
3.2.10 Discussion of Strategic Fit

To summarize, the bank's overall strategic fit with a differentiation strategy is questionable or muddled. While the original concept behind Citizens was to take the Vancity model national, Citizen's overall degree of fit within Vancity's solid differentiation strategy is fundamentally less clear. The aspects that successfully differentiate Vancity within the BC Lower Mainland--its values focus and involvement of the local communities--are values that are somewhat less appealing and potentially more challenging to execute as part of a national virtual bank's value proposition. Consequently, Citizen's strong CSR positioning and better pricing can be perceived as somewhat at odds with each other. Furthermore, CSR is no longer a strong differentiator with most banking players having a solid level of CSR. In the banking industry, a self-service model is inextricably tied to better value through lower prices in exchange for less face-to-face contact. Direct competitors such as ING Direct and PC Financial (backed by CIBC's Amicus division) follow clear low cost strategies and have been able to build the necessary scale or partner to utilize existing infrastructure.

3.3 Value Chain

This section analyzes how Citizens Bank creates value as an organization, both within an industry context, as well as specifically at the firm level. The bank creates value in two key areas, by acting as a financial intermediary between depositors and borrowers, and the strong service orientation and attitude embodied in the company culture, values, and employees.

3.3.1 Industry Value Chain: Retail Banking



Source: Adapted from Bukszar Class Notes 2005

3.3.1.1 R&D

Research and development within the retail banking industry consists of gathering information about changing customer needs and preferences, staff training to enhance knowledge, and technological developments. Information about customer needs and preferences, and also industry developments are gathered through both primary and secondary market research. Primary market research (focus groups, surveys) conducted by the financial institution (FI) will typically have an outsourcing element (e.g., hiring a research supplier such as Ipsos-Reid to conduct surveys and/or focus groups, and prepare results). Despite the size of internal teams, large FI's, the big five banks) still use external research suppliers for the high level of technical expertise that they would not maintain in-house. Secondary research such as consulting firm industry reports or Statistics Canada information. would generally be outsourced unless an FI is

re-using primary research previously conducted by them. Citizens Bank leverages the expertise of Vancity's in-house market research team by gaining access to primary research conducted by Vancity or any secondary research purchased by Vancity. The bank also outsources primary research on an as-needed basis.

Within the industry, training to enhance staff knowledge is done both internally and externally with the bulk of training likely outsourced. Outsourced training would include accredited programs such as the Canadian Securities Course, the Certified Financial Planner designation, or Canadian Bankers Association courses, Dalhousie's MBA specializing in Financial Services, and more general business courses available from various educational institutions. Citizens Bank uses a combination of internal training developed and facilitated by in-house or contracted instructors as well as externally offered courses.

New developments within the technology area are typically outsourced to specific application providers or conducted through partnerships or cooperative ventures among industry players. For instance, Citizens Bank and Vancity both use a CGI banking platform or central nervous system for retail banking transaction processing that extends to multiple channels such as the call centre, website, retail offices and IVR. Technology developments are discussed further in the service delivery section.

3.3.1.2 “Production” of Product and Services

In the banking industry, the bulk of retail banking products and services are typically “produced” so to speak, in-house with each FI training and developing front-line employees to provide quality service, product development teams putting their own spin and branding on to what would otherwise be homogeneous deposit accounts, term investments, personal loans, residential mortgages, credit cards, and mutual funds, brokerage, and discretionary investment management services from larger players such as the big five banks. Typically only ancillary products and services such as cheque printing and sometime bank card production and embossing are

outsourced. Citizens Banks produces all of its retail banking products with the exception the ancillary services noted and wealth management products and services such as mutual funds and brokerage services which are outsourced to Credential Financial Inc., the wealth management provider to the Canadian credit union system.

3.3.1.3 Marketing

Functions within marketing include product development and marketing, marketing communications, advertising, database marketing, web marketing, public relations, direct mail, and promotions. Most FIs, including Citizens Bank, use a combination of in-house marketing as well as specialized marketing suppliers where applicable (e.g., advertising agency, marketing research, web marketing firm, direct mail house, etc).

3.3.1.4 Sales

On the retail level within both the industry and Citizens Bank, sales are handled primarily through the FI's proprietary distribution network (branch, call centre, website) with the exception of residential mortgages, which are also sold through mortgage brokers, as well as investment certificates and mutual funds, which are also distributed through the third party investment dealer channels.

3.3.1.5 Delivery

For certain products, the timing product or service delivery will be concurrent with the sale process (bank accounts, term deposits), while for certain products, distribution and delivery will occur at a later date (e.g., mortgage funding usually occurs at a subsequent date to when the customer verbally agrees to the bank's mortgage offer, or one will receive a credit card in the mail two to three weeks following the initial application). Product delivery is typically dependent upon an existing technology and system infrastructure that is external to the FI, from payment and clearing services through Symcor, a joint venture established by BMO, Royal Bank and TD in

1996, to the Interac shared ATM and direct payment network, a cooperative venture by five major FIs, or even the Visa or Mastercard networks. Citizens Bank which is affiliated with the credit union system through its parent company, outsources its payment and cheque clearing to Credit Union Central of BC (CUCBC).

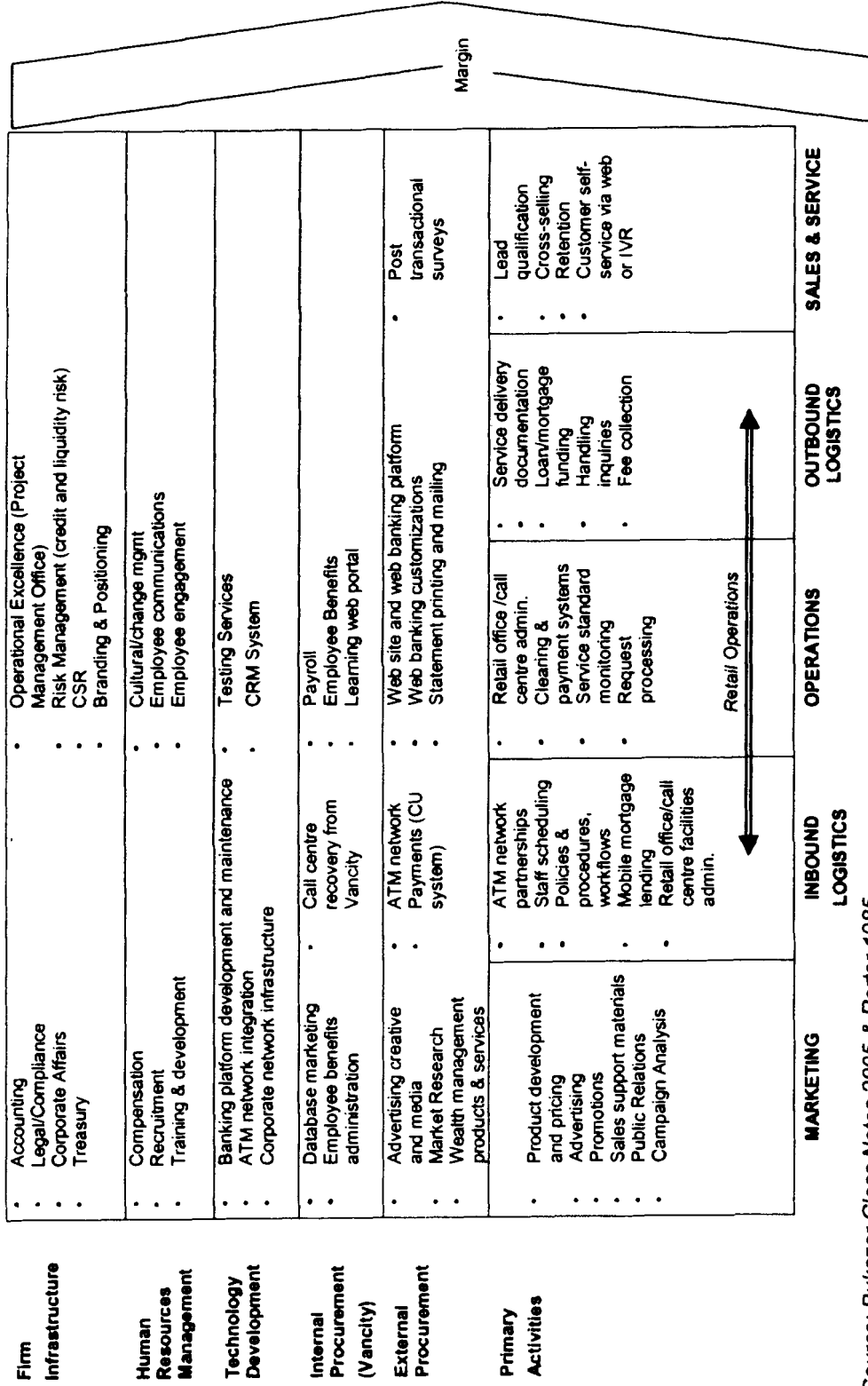
3.3.1.6 Servicing

Servicing typically handled in-house as a key component of retail bank offerings and customer satisfaction and retention. In the mature banking industry where many products are viewed as near homogeneous offerings by consumers, FIs have tried to differentiate their offerings through personalized service and relationships. While larger global banks in the UK have been moving back-end processes such as processing and administration offshore³⁰, the extent of such offshoring activities appears to be limited or non-existent thus far within Canadian banks for time being. With increasing pressure to grow revenues and achieve further cost savings, offshoring of certain activities may not be too far in the future for Canadian banks.

3.3.2 Firm Level Value Chain: Citizens Bank

³⁰ European Industrial Relations Observatory Online <http://www.eiro.eurofound.eu.int/2004/05/feature/uk0405103f.html>, accessed March 12, 2005.

Firm Level Value Chain: Citizens Bank



3.3.2.1 Firm Infrastructure

Firm infrastructure includes the typical accounting and legal and compliance functions. Legal is outsourced to McCarthy Tétrault on a case-by-case basis, ranging from a legal opinion on product or brand-related trade marking and wording used in an ad campaign to specific customer issues. As an institution regulated under the federal Bank Act, Citizens Bank must file regular reporting with the Office of the Superintendent of Financial Institutions (OSFI) to ensure compliance with its guidelines. This regular reporting covers solvency requirements (capital adequacy, prudential standards (large exposure limits, portfolio mix), and accounting standards (non-accrual loans, disclosure requirements). This reporting pertaining to external governance is managed internally by the Corporate Affairs area. Corporate Affairs also leads any lobbying efforts, either on our own or in tandem with other FIs around proposed amendments to existing banking legislation.

The bank's compliance function ensures adherence to industry reporting requirements relating to money laundering and terrorist financing from the government agency, Financial Transactions and Reports Analysis Centre of Canada (FINTRAC). Another component of the compliance function is ensuring Citizens Bank complies with any industry standards from the Canadian Payments Association, who operates and facilitates the national payment and settlement or clearing system for FIs. Industry standards include changes to cheque specifications to facilitate more efficient clearing, set-up and ongoing administration of pre-authorized debits, new rules for online payments involving a bank account direct debit instead of a credit card payment. Citizens must also comply with any consumer protection laws and is monitored by the Financial Consumer Agency of Canada (FCAC) in this area.

The treasury and risk management functions are tied closely. Treasury includes cash management: management of daily cash balances given inflows from loan interest and outflows for interest paid on deposits, investment of surplus funds, and cash-flow forecasting and management, pricing of deposit and lending products, management of F/X exposure through CB's F/X trading function within defined risk management guidelines. Another aspect of risk management relates to the credit function, whose mandate includes the development and maintenance of lending criteria, portfolio guidelines to minimize undue exposure to the bank.

Within Citizens, the Operational Excellence (OE) area acts like a project management office by instilling a standard project management discipline across all major company projects in an effort to boost efficiency and tighter monitoring of these projects. OE project managers are available to internal departments on a time and cost basis and their role includes project managing people, processes and technology updates.

The Corporate Social Responsibility (CSR) function within Citizens Bank develops and maintains the bank's ethical policy and corresponding programs including the Shared Interest donation program, and ongoing partnerships with Amnesty International and Oxfam Canada through a jointly branded Visa donation program in which Citizens contributes an amount to the respective organization on a per use basis. In addition to initiatives specific to the CSR department, the CSR also heads up broader initiatives that integrate CSR ideals and values into the organization, such as company-wide ethics training for all staff or a screening tool to assist various areas of the organization in assessing potential business partners and suppliers.

Development of Citizen Bank's branding and value proposition within the retail banking area is led by the marketing function. The definition of organization's brand promise includes an assessment of how Citizens will fulfill this promise from a product and service offering standpoint while also seeking to differentiate Citizens Bank within the broader marketplace.

3.3.2.2 Vancity Integration

3.3.2.2.1 Strategy Formation

The bank's strategy has generally been formulated independent of the parent company, Vancity, however, strategic initiatives are vetted by the bank's board, which is chaired by the CEO of Vancity. Vancity's SVP of Risk and Operations as well as the chair of Vancity's board also sit on the Citizens Bank board. Strategy formation within Citizens Bank largely occurs at the Steering Committee level, which is comprised of VPs and SVPs representing each functional area of the organization depicted in Figure 4. These areas include Operations, Marketing, Human Relations, Finance and Treasury, Credit, and Residential Mortgages and Strategic Alliances.

3.3.2.2.2 Head office functions

The integration of select functions between Vancity and Citizens Bank has been one of the bank's key business strategies to reduce its share of the initial investment costs and increase efficiency levels. In 2002, the call centre and commercial mortgage team functions were merged between both companies. In the past year, the integration of other head office functions between Citizens Bank and Vancity has increased with the Privacy, Corporate Social Responsibility/Sustainability, and Corporate Affairs, Governance/Compliance functions integrated within Vancity. CSR, Corporate Affairs and Compliance integrations were undertaken in the spring of 2005.

3.3.2.3 Human Resources Infrastructure

The HR infrastructure includes employee recruitment and compensation as well as change management expertise and leading employee engagement plans, a key corporate performance measure, across the bank.

Consistent with its parent company, Citizens Bank views itself as having employee-centric values among its broader social, environmental and community values. The cultural fit of employees is an important part of the recruitment process. The Citizens Bank human relations team handles employee recruitment internally in terms of working with the hiring manager to finalize the job

posting if needed, the evaluating resumes to forward to the hiring manager, and conducting initial screening (phone or in person interviews) before the candidate meets with the hiring manager. Reference checks are outsourced to a third party company.

As described earlier, Citizens Bank uses a combination of internal training developed and facilitated by in-house or contracted instructors as well as externally run courses. Since regular and ongoing communication is seen as a critical component of successful change initiatives and overall employee engagement, internal communications are a key output of the HR function within Citizens.

Human Relations leads company-wide employee recognition initiatives such as the annual staff forum in which employees receive an update about the bank's key strategic initiatives in an "infotainment" presentation format, the banks' annual recognition week which includes a CEO-hosted barbecue for all employees at the Vancouver head office and department sponsored events to recognize other departments they regularly interact with, a bimonthly Executive luncheon for 20 to 25 employees with the CEO and another member of the bank's steering committee.

Employees are evaluated through a performance partnership program developed jointly by the employee and his or her direct supervisor. The program includes identifying the key success areas for each roles and developing quantitative and qualitative performance measures depending on the nature of the employee's role. Salary increases are based on both market adjustments as well as a combination of individual performance ratings and the bank's overall performance against its corporate targets. Depending on the bank's performance, bonuses are paid out on an annual basis shortly following the bank's year end. Human Relations coordinates the overall employee evaluation program, providing support to people managers through one-on-one coaching and follow-up around key dates for submission of evaluations.

3.3.2.4 Technology Development

The bulk of technology development is actually outsourced to external partners with Inventure Solutions handling the technology integration and configuration of new products and enhancements to existing systems. Inventure Solutions Inc. is a Vancity subsidiary that provides technology solutions to the Vancity group of companies (of which Citizens is a member) as well as to other credit unions and affiliated organizations. Some of Citizens' external technology partners include ATM network providers, Ficanex, the operator of the EXCHANGE[®] ATM network provider in Canada, and Acculink, the credit union ATM network, CGI systems (supplier of the Retail Financial Services, retail banking platform), Siebel for Customer Relationship Management technology, Microsoft for general office applications and Credit Union Central of BC's (CUCBC) technology group for the website and online banking platform.

3.3.2.5 Procurement

Procurement activities at Citizens Bank can be divided into two main groups: internal procurement which refers to services or activities which are either outsourced or co-sourced with Vancity, usually through a Service Level Agreement (SLA), or external procurement which involves suppliers external to the Vancity group.

Internal procurement arrangements include technology support from Inventure discussed above, human resource administration support for payroll and benefits and on the marketing side, specific marketing services such as database marketing, market research, and also interactive services relating to the implementation of website and web banking functionality. Through a similar but reverse arrangement, Citizens Bank's call centre recovers part of its costs by handling Vancity calls in addition to those for Citizens.

External procurement in the technology area has already been described briefly above. Citizens Bank does not operate its own ATMs for cost reasons and has instead elected to be a member of

the established EXCHANGE and Acculink ATM networks, to which most of the Canadian credit union system belongs.

Other activities outsourced include creative development, public relations consulting, market research and media buying to an ad agency, and website and web banking platform development and maintenance. Citizens Bank along with a number of credit unions, including Vancity, uses a web site infrastructure from CUCBC through a licensing arrangement. This website infrastructure includes not only hosting services but also access to an enterprise-level content management system for publishing web content by non-technical bank/credit union staff as well as an online banking interface which integrates with the bank's own banking platform to allow customers to access their account details, pay bills, transfer funds, and also open additional accounts.

3.4 Primary Activities

3.4.1 Marketing

Marketing activities have been in maintenance mode over the past few years with the bulk of retail assets acquired through intermediaries such as brokers, real estate agents and Strategic Alliance partners (e.g., Homeworks Loan program). In addition, between the bank's launch in 1997 and late 2004, very limited new marketing initiatives were in place due to an internal focus on streamlining operations and related efficiencies over the past few years. Now with the bank looking to expand to grow retail members and build its brand, marketing activities have been renewed.

Marketing activities within Citizens include the development of products to meet both changing consumer needs as well as keep pace with competitive offerings. These products include a high interest savings account, an aggressively-priced variable rate mortgage product, and a mortgage offering tied with value-added discounts and offers. In terms of overall product development process, a product marketing plan is typically developed by a product or marketing manager. The

product marketing plan will include an analysis of product category trends, an assessment of competitive offerings, a proposed product and its specifications, and a discussion about how the product fits within the current product suite. The product manager will then work together with a representative from Treasury on a capital expenditure analysis relating to the product launch, which will look at the financial margin under various market and cannibalization scenarios. Once the product marketing plan and financial analysis are approved at the Steering Committee level, a project team is created with representatives from marketing, the relevant areas of the NCC (e.g. lenders for credit products), Inventure Solutions, Retail Operations, and if the web banking system updates are required, Interactive Services and CUCBC. The overall mandate of the project team includes solidifying the product specifications based on operational and system capabilities, and implementing any operational changes (e.g., systems, processes and procedures) and employee training arising from the new product launch.

A parallel but separate project relates to the product launch. From a launch perspective, marketing provides direction to the ad agency with respect to creative development and marketing will either develop sales support materials such as direct mail letters, brochures, web copy in-house or in conjunction with the agency. Following campaigns and launches, the marketing lead will typically complete the analysis with respect to product penetration, leads, closed sales, and customer feedback reports.

3.4.2 Retail Operations

Within the context of this value chain analysis, inbound logistics, operations and outbound logistics-related activities would fall under the Retail Operations umbrella. Inbound logistics include the scheduling of shifts of the over 250 call centre staff members to ensure sufficient coverage at the 24-hour call centre based on call volumes, scheduling and holding training, development and documentation of workflows as well as policies and procedures to deliver consistent service and provide reference materials for front-line staff, as well as the administration

of call centre and retail office facilities from equipment repair and maintenance to cleaning and janitorial services.

Key operations functions of the four-person Retail Operations team include the development and maintenance of documented policies and procedures, overseeing the bank's ATM network memberships and set-up and maintenance of the bank's proprietary ATMs, supporting the two retail locations through facilities management and maintenance, and finally, establishing and maintaining supplier relationships for items such as cheque printing, statement production, ATM card machines to re-PIN cards, and bank card production and embossing.

3.4.2.1 Policies and Procedures

The bank's documented policies and procedures cover both product information as well as instructions regarding how to set up and amend products on the bank's various systems. These policies and procedures are published on the corporate intranet and are both created and maintained by a member of the Retail Operations team.

3.4.2.2 ATMs and Bank Cards

Activities related to the bank's ATMs cover both proprietary ATMs (machines owned by the bank) as well as memberships to the existing Ficanex and Acculink national ATM networks. The bank currently only owns one ATM which is located inside the Waterfront branch, and there are plans to add a second ATM within the Calgary branch. For proprietary ATMs, Retail Operations develops and coordinates processes to service the bank's sole proprietary ATM including the secure pick up of deposits as well as cash replenishment. For the Ficanex and Acculink networks, Retail Operations manages the legal agreements, and corresponding activities related to the bank's membership to these networks, such as ensuring the bank continues to satisfy the network's membership requirements, and initiating projects to display ATM location information on the bank's website.

Retail Operations is also responsible for establishing and maintaining supplier relationships relating to the production of Citizens Bank branded bank cards and arranging the processes to personalize and mail bank cards to members. In addition, both the Vancouver and Calgary retail locations, and Toronto office have machines to set up new PINs (Personal Identification Number) on existing cards. The sourcing and maintenance of these re-PINing machines fall within the Retail Operations domain.

3.4.2.3 Payment Services

Payment services include the processing of Canadian dollar and US Dollar clearing items (e.g. cheques and any returned items such as NSF cheques), automated funds transfer between Canadian financial institutions, and settlement for bill payments, ATM, and POS network settlement. All of these activities are outsourced to Credit Union Central of BC (CUCBC) with Retail Operations managing this relationship.

3.4.2.4 Statement Production

The bank sends statements detailing account activity to its members on a monthly basis. As with a number of other financial institutions, statement printing and mailing is outsourced to an external service supplier. The bank uses Intria Items Inc., a joint venture between CIBC and Fiserv. Fiserv is a US technology and service provider to the financial services industry with more than 13,000 clients in 60 countries. Intria serves not only the financial sector, but also utilities, retail, and government. Retail Operations is responsible for the Intria relationship within the bank.

Outbound logistics include delivery of the actual service through the set-up of accounts on the banking system, activating a customer's personal access codes or bank card, following up on

documentation to be received (e.g., cheques for initial deposits, real estate purchase agreements for mortgages, income confirmation) to move an application to the next stage, and also the distribution of any related documentation, such as welcome kits for new clients, mortgage instructions for lawyers or notaries, and finally the actual funding of loans and mortgages. These activities are handled by staff in the Retail Locations as well as NCC staff. Handling inquiries via e-mail, phone and the web are also part of outbound logistic activities.

While outsourcing is used for back-end processing (payment and clearing systems), limited outsourcing is done from a front-line service delivery perspective, relying instead on trained in-house CB employees to maintain control over the quality of service delivery.

3.4.3 Sales & Service

Sales and service are bundled together in the final remaining area of primary activities which encompass lead qualification for relevant products, cross-selling to new or existing customers, and also retention-related activities. Overall, sales and services processes can be characterized as largely manual in terms of processing, administration and reporting. While a combination of internal (i.e. procedures around risk assessment, debt service ratios, suspected terrorist lists) and external information sources such as credit bureau information through providers such as Equifax are used in the qualification process depending on the product, ultimately the go/no-go decision is made internally.

Approximately 56% of loans are adjudicated through the bank's automated loan decisioning software application which incorporates a scoring system based on the bank's credit granting criteria. The remaining 44% of loans are manually adjudicated by lenders with discretionary lending limits. Lenders acquire these lending limits through an accreditation process involving

both in-class training and a practicum component whereby their credit analyses and recommendations for a limited number of live deals are judged by senior lenders.

Cross-selling related products and services to existing customers involves front-line staff and in some cases, marketing activities for campaigns to the existing customer base. Retention activities would typically involve an existing customer requesting an interest rate match for a deposit or lending product, or alternatively, a service issue and both require direct contact from front-line staff for resolution or approval of a rate exception.

Servicing can crossover from the outbound logistics phase and can include various channels (call centre and retail) as well as self-service channels such as the website and IVR. Post-transaction and annual surveys are conducted to measure service quality and develop training plans. These surveys are usually outsourced to an external supplier.

3.5 Value Creation – Citizens Bank

Citizens Bank creates value in two distinct areas: acting as a financial intermediary by developing products which borrow capital from depositors and lend it out to borrowers, and in embodying a strong service orientation and attitude which Citizens Bank has termed "extreme service". This focus on member service is not a surprise given the credit union roots of Citizens Bank's parent, Vancity and the importance of building and maintaining the customer relationship in the financial services industry. In terms of maintaining a high quality of service, Citizens does the same things that competitors do in terms of measurement, benchmarking and the rollout of customer service programs. However, extreme service is a central component of Citizens' corporate values and a significant portion of company resources are committed to this service endeavour.

Interestingly, service within the banking industry is a double-edged sword; while sufficiently high service levels are necessary to be a player in the financial services industry, in today's highly

competitive and mature industry, customers demand both competitive prices and relatively high service levels. As a result, unless a company is providing a high level of personalized service to the premium segment (e.g., private banking) and receiving the corresponding fee income to support these service levels, it is very difficult to differentiate on the basis of service in the mass segment. This difficulty is magnified within the lower-cost virtual banking arena where competition is primarily based on price.

Increasing pressure on margins has shifted the focus to volume and scale, and this pressure is unlikely to subside in the future. While outsourcing within the retail banking industry has primarily been limited to back end processing, administration and IT support thus far, are Canadian banks poised to follow in the footsteps of the IT industry and next look to outsource a service component in an effort to further trim costs? For an organization focused on social and community values such as Citizens, the decision to do so is highly unlikely without significant changes internally.

3.5.1 Firm Culture

Key facets of the bank's culture are its service orientation and attitude, deeply held values of stakeholder engagement, and keen focus on employees.

3.5.1.1 Service Orientation and Attitude

As described in the previous section, the bank is focused on providing high service levels through the attitude of extreme service and has even integrated language around the extreme service concept within its mission statement. Reinforcing a strong service orientation requires both internally and externally focused initiatives. Internally, stories demonstrating the attitude of "extreme service" in action are shared with staff on an ad hoc basis as well as in quarterly management meetings. A committee called the Member Extreme Experience Taskforce (MEET) was formed to provide a consistent and holistic member experience across the key channels of

the bank with representatives from the call centre, IVR, web, retail offices, human resources and marketing and meets biweekly to discuss trends in member feedback reports, the impact of new initiatives or changes to the member experience to the various channels.

An internal service platform initiative was launched in late 2004 to orient all departments around mutually agreed upon service standards specifically for internal customers. All departments within the bank identified their internal customers and developed a list of measurable service standards, which were then approved by internal customers. The next phase of the service platform initiative involves the development of an ongoing mechanism to measure and report how well departments are performing against their internal service standards.

Externally, the call centre tracks both quantitative metrics such as the average wait time, as well as qualitative metrics around whether accurate information was provided on an ongoing basis. Trends in member feedback are analyzed with particular attention paid to member inquiries which take more than 24 hours to resolve. Post transactional surveys are also conducted to assess member satisfaction following a service encounter with the bank.

As with most banks and financial services players, Citizens Bank is trying to shift this keen focus on service to more of a “sales and service” culture. A communication theme to staff has been aimed at overcoming the negative perception of a sales culture. Furthermore the bank has recently rolled out sales training to equip front line staff with a sales process and methodology.

3.5.1.2 Value of Stakeholder Engagement

The concept of stakeholder engagement is rooted in the principles of corporate social responsibility and involves identifying those (internal and external to the firm) with a vested interest in a particular project or initiative and seeking their input and buy-in during the process to ensure a greater acceptance and probability of success upon completion.

The notion of stakeholder engagement values consensus-building, dialogue, harmony and egalitarianism, and are rooted in Vancity's credit union values and ideals as an organization that actively engages a broad group of stakeholders. Similar values are reflected internally within the bank through its decision making process which generally emphasizes input from a wide spectrum of areas to build consensus, facilitate communication and ensure buy-in. As an example, major projects are vetted through multiple committees, which provide the opportunity for much discussion and debate, but also slows down the decision-making and overall implementation process. The process of engaging the committees is also somewhat bureaucratic, meeting minutes and action items are formally documented. Status updates on action items are brought back to the committees so that their completion can be properly recorded in the minutes.

This aspect of the bank's culture discourages autonomy primarily because to gain broader acceptance, one needs to be inclusive and gather input from all relevant parties. The balance between the appropriate level of engagement versus speed of implementation requires active management. The emphasis of internal key stakeholder support has led to a slight inward focus and the formation of an external myopia to broader market conditions and competitive realities. Ironically, despite the bank's stated focus on member, there is a tendency for initiatives to shape and change based on what will be internally accepted (employees, board) than being driven primarily by the external customer and market conditions.

3.5.1.3 Employee Focus

The belief that engaged employees provide better service to members is deeply held at the bank. As a result, employee engagement is not only a key performance indicator for the bank, but also an important element of the bank's culture. The bank, as part of the Vancity group, is especially proud of being recognized as Canada's Top Employer in 2004 by MacLean's magazine. The

bank's commitment to its employees is manifested through its competitive compensation (both monetary and non-monetary), employee recognition efforts, regular opportunities for employees of all levels to interface with members of the bank's senior management team, and resources dedicated to employee communications.

3.6 Financial Analysis

3.6.1 Internal Key Performance Indicators

Citizens Bank's financial established a variety of key performance indicators against which it measures its financial performance.

3.6.1.1 Return on Equity (ROE)

Return on Equity (ROE) is a measure of how well the bank has utilized funds invested by shareholders and retained earnings. ROE is calculated by dividing income by average common shareholders' equity. Citizens Banks' 2004 actual ROE of 6.41 is substantially below industry benchmarks.

Table 5: ROE Comparison

Big Six Banks versus Citizens Bank, Fiscal 2004

BMO	19.4%
BNS	19.9%
CIBC	18.7%
NBC (National Bank)	18.8%
RBC	15.9%
TD	14.8%
Big Six average (equally weighted)	17.9%
Vancity Group of Companies	13.0%
Citizens Bank	6.41%

3.6.1.2 Efficiency Ratio

The efficiency ratio reflects how well the bank has controlled non-interest expenses relative to the revenue earned. This ratio is calculated by dividing non-interest expenses by total revenue (net interest income before the credit loss provision plus other income). Non-interest expenses consist primarily of employee salaries, equipment and premises costs, and other expenses. Expenses categorized as other expenses include communications, marketing, professional services, office supplies, and stationery. In 2004, the bank's efficiency ratio was 86.3%, which is high compared not only to its parent company, Vancity, but also versus the six largest Canadian banks as illustrated in the table below.

Table 6: Efficiency Ratio Comparison

Big Six Banks versus Citizens Bank, Fiscal 2004

BMO	65.0%
BNS	57.6%
CIBC	69.4%
NBC (National Bank)	67.0%
RBC	71.5%
TD	74.0%
Big Six average (equally weighted)	67.4%
Vancity Group of Companies	73.8%
Citizens Bank	86.3%

The bank's high efficiency ratio relative to competitors and its parent can be attributed to a number of reasons. Growth in non-interest expenses of 64.3% outpaced revenue growth of 46% during the period 2001 to 2004. The expense category that grew the most during 2001 to 2004 was that of Salaries and Employee Benefits (160%), reflecting the integration of the previously separate Citizens Bank and Vancity call centres as well as increases in the number of

full time equivalent (FTE) staff. These expense growth patterns are also likely indicative of Citizens Bank's stage in the start-up or growth phase of the organizational life cycle, compared to the major banks³¹, all of which have been in existence for 130 years or more. As an example, from 2003 to 2004, other expenses at BMO, BNS, CIBC and NBC increased a fairly modest 2% to 7%³².

Furthermore, the major banks and even Vancity (with a member base over ten times that of Citizens Bank) enjoy significant scale advantages which allow them to spread their costs over with substantially larger customer base. Within the virtual banking realm, the realities on the cost side are even more pronounced in a rough comparison between Citizens Bank and ING Direct. While one could argue that a comparison between the two organizations is not an apples-to-apples comparison since ING Direct is not a full-service bank offering chequing capabilities and payment processing like Citizens Bank, the rough comparison in Table 7 nevertheless illustrates the significant cost challenges faced by Citizens Bank in competing in the virtual banking arena.

Table 7: Rough Comparison of Citizens Bank to ING Direct

	ING Direct	Citizens
Total employees	750	437
Total assets (in 000's of \$)	14,000,000	1,500,000
Total number of customers (in 000's)	1,000	25
Number of employees per 1,000 customers	0.75	17.48
Number of employees per \$1,000 in assets	0.05	0.29

ING Direct has approximately 750 staff to serve over 1 million clients in Canada with over \$14 billion in assets. The bank on the other hand has approximately 437 employees to serve approximately 25,000 members with a total of \$1.5 billion in assets. In other words, the bank

³¹ Refers to Canada's six largest banks

³² Canadian Banks 2005, Perspectives on the Canadian Banking Industry, PricewaterhouseCoopers LLP, March 2005.

requires roughly 23 times the number of employees to serve the same number of customers as ING Direct and nearly 5.5 times the number of employees per \$1,000 in assets.

3.6.1.3 Credit Loss Provision

The credit loss provision is an amount charged to the income statement indicating the level deemed appropriate by management to absorb any credit related losses. The credit loss provision reflects the quality of the bank's total loan portfolio. The table below shows the trends in the level of the bank's credit loss provision both in dollars and to facilitate comparison with the other major banks, as a percentage of total loans. Citizens Bank's official calculation expresses the credit loss provision as a percentage of risk-weighted assets which applies different risk factors to the various loan types based on their respective weighting in the bank's overall loan portfolio. The risk weighted calculation is not presented in this paper.

Table 8: Citizens Bank Credit Loss Provision
Citizens Bank Loan Assets by Type as at December 31, 2004

Residential Mortgages	71.7%
Commercial Mortgages	16.4%
Consumer & other	11.9%
	100.0%

in 000's of dollars

	2001	2002	2003	2004
Credit Loss Provision	\$ 3,385	\$ 2,319	\$ 1,543	\$ 350
Total Loans	\$ 1,077,708	\$ 1,157,500	\$ 1,195,301	\$ 1,417,480
Credit Loss Provision as % of Loans	0.31%	0.20%	0.13%	0.02%

As with most major banks, the provision for credit losses has declined significantly at Citizens Bank over the past few years. The combined provision for the big six banks in 2004 was 0.10% of

total loans (and bankers' acceptances), a reduction of 73% from 2003. The Vancity Group's credit loss provision stood at 0.12% of total loans. Should market interest rates increase, the credit loss provision will also increase, reflecting a higher likelihood of loan default or losses.

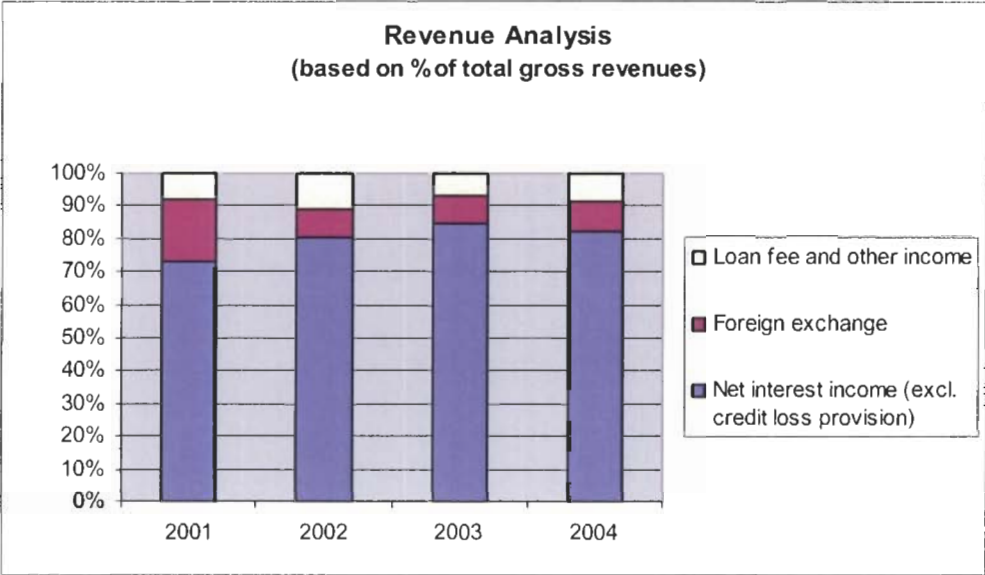
3.6.1.4 Growth and Profitability Trends

Earnings from operations experienced significant growth from 2001 to 2003 but this growth pattern reversed in 2004, when earnings from operations fell by 44% to \$3,483,000. This reversal is largely due to slowing revenue growth (7%) while operating expenses continued to climb (22%) in 2004.

On the revenue side, net interest income has experienced the most growth in dollar terms over the past four years and still accounts for the lion's share or 83% of the bank's revenues in 2004, up from a high of 85% in 2003 illustrated in Figure 5 below. This decline in net interest income as a percentage of total income was also observed in the broader banking industry with four of the big six banks, BNS, TD, BMO, and CIBC experiencing declines³³.

³³ Canadian Banks 2005, Perspectives on the Canadian Banking Industry, PricewaterhouseCoopers LLP, March 2005.

Figure 5: Citizens Bank Source of Revenues (%)



The key difference for the major banks is that net interest income represents a much smaller proportion of total income, ranging from only 39% to 58% of total income. Although the Vancity group continues to target growth in other income as the group strives to offer a full array of financial services to its members, net interest income for the group represented approximately 79% of total income in 2004.

4 ISSUES

4.1 Short Term

In the short term, the interest rate outlook and broader economic conditions have the potential to impact Citizens Bank's earnings growth over the next few years, given that over 80% of the bank's revenue is derived from interest income or financial margin. Should rates increase, the slowing demand for credit and increased credit loss provisions to reflect a higher likelihood of credit losses could be a double whammy on earnings.

4.2 Medium and Long Term

4.2.1 Forced Migration to Cost-based Strategy

The most significant issue facing the bank overall is that the combination of industry dynamics, competitive virtual banks, and branchless banking distribution model forcing CB to migrate to a cost-based strategy from its differentiation strategy roots as the member advocate national arm of Vancity with a triple bottom line focus and a publicly stated Ethical Policy.

While the business strategy of an internet or branchless bank would typically lend itself to a cost-based strategy, this is not the case with Citizens Bank, whose stated and internally endorsed strategy (both by senior management and the board) per the five year strategic plan is to differentiate itself through service and act as an advocate for the member by acting in the members' best interests.

Taking into account the competitive realities of the branchless banking model, the likelihood of Citizens Bank successfully differentiating itself through service to acquire 50,000 new members over the next four years is remote. Not only do a substantial portion of respondents in the bank's

2004 member survey cite "rates/fees" as the top reason why they joined the bank, the ability to lure technology savvy customers comfortable without a traditional branch network from incumbent players requires a compelling offer in an increasingly commoditized financial services marketplace. Without product breadth or particularly innovative products, increased convenience beyond what existing competitors offer (all of the big five offer internet banking functionality in addition to their extensive brick and mortar networks), and/or significantly superior service levels in terms of response time or even service variety, the bank has little choice but to base this compelling offer on price to achieve its growth targets set out in its strategic plan.

Price competition can only be viable with an underlying cost-based strategy. While the bank has a number of variables lined up or migrating accordingly such as a rapid follower product strategy, low R&D approach, centralized organizational structure, and relatively low risk profile, shifting to a cost-based strategy will be particularly challenging for the bank on a number of fronts.

With regards to the manufacturing function and its scale/scope orientation, retail banking is by nature a scale business whereby higher output levels (both in terms of number of new accounts or mortgages and average transaction size) allow the bank to spread its fixed costs for infrastructure and other costly inputs over a greater number of members, products, as well as a larger asset base. With a current base of only 20,000 members, the bank is at a significant scale disadvantage compared to the substantial numbers of customers possessed by the major banks with 8.5 million to 11.5 million³⁴ customers or even its direct virtual banking competitors, ING Direct and PC Financial with over 1 million and 1.9 million customers respectively. Even when including the parent's client base of 300,000 members, the combined member base of Citizens Bank and Vancity is still relatively small.

For the labour variable, a shift towards mass production rather than skilled labour would involve significant investment in technology and automation of processes, such as account opening,

³⁴ As reported on the public websites of BMO, BNS, CIBC, TD Canada Trust, RBC. Figure also includes small business and commercial customers in addition to personal banking.

administration, and reporting, that are largely manual and labour intensive in nature. As a result, even a single member acquisition campaign targeted only to the BC Lower Mainland required additional staffing and resourcing at the NCC, the bank's primary sales and service channel. This is in sharp contrast to ING Direct, for which rapid growth has not necessitated significant expansion in its call centre infrastructure. This scalability is primarily due to an account opening process that is mostly automated and in the US, where its operation modelled after the original Canadian pilot, 70% of transactions and customer service transactions occur over the Internet³⁵. Any sizeable process automation initiatives will result in corresponding reductions in head count.

On the marketing front, although a cost-based strategy calls for comparative push marketing, because the bank is aiming to increase its presence in the direct-to-retail market, the bank needs to shift to more pull-based marketing for broader brand building and awareness. Pull marketing and other challenges to increasing the bank's retail presence are discussed in a subsequent section.

A challenging barrier to the bank's shift to a cost-based strategy will be of a cultural and philosophical nature. A low cost or cost-based strategy is viewed internally to be entirely at odds with the bank's values, employee focus and stakeholder engagement approach which takes into account the needs of employees, members, and the broader community as a whole. A cost-based strategy is also perceived as focusing too narrowly on the financial bottom line, and eschewing the Vancity group's broader triple bottom line orientation, and to a larger extent, the values of the cooperative movement upon which credit unions were founded.

Furthermore, the five year strategic plan covering the period 2004 to 2008 and the approach to differentiate on service and member advocacy was formally approved by the bank's senior management team and board in 2003. The strategic plan is not up for review until mid-2006 and there appears to be limited appetite for accelerating the review date.

³⁵ ING Direct, Karen Ragaust, *Advertising Age*, November 1, 2004, Vol. 75, Issue 44, pS-12, 1c

4.2.2 High Cost Structure

The most significant challenge to the bank's shift to a cost-based strategy is its high cost structure. The bank simply cannot sustain price-based competition beyond the short term as evidenced by its efficiency ratio of 86.3%, which represents the bank's cost to earn a dollar of revenue. In addition, its major competitors either have deep pockets or like ING Direct and ICICI Bank, are backed by parent companies of global proportions and significant resources.

In assessing target areas for cost reductions beyond the automation and head count reductions mentioned in the preceding section, the bank already has limited real estate (typically the largest "other expense" type after salaries for the banks), and has already outsourced some back office processes to larger, more efficient providers for payment and cheque processing as well as statement printing and mailing. These are the same providers used by Vancity for its member base. The likelihood of squeezing significant additional cost savings from these areas is low. As for reducing corporate overhead, the integration of the Privacy, CSR, Governance and Compliance functions with Vancity have occurred within the past year.

In terms of the ease of automating processes through systems upgrades and enhancements, since Citizens Bank usually only pays a fraction of the overall cost and due to the scale of systems upgrades, the bank usually follows the timing of Vancity's upgrade and enhancement schedule. The ability for Citizens to wield more influence around the timing and extent of updates unless they also apply directly to Vancity, is restricted overall unless the bank had sufficient resources to pay for and manage large scale systems projects outside of Vancity's schedule.

Another potential area to explore potential cost savings and increase the bank's product focus would be through a profitability analysis of the each product within the bank's retail product line-

up, particularly chequing accounts. Offering chequing accounts requires significant back office infrastructure (whether in-house or outsourced) around cheque clearing and payment processing, cheque printing, collections, tracing, etc, as well as the time of front line staff to handle inquiries and questions. ING Direct has intentionally stayed away from offering chequing accounts in Canada, instead exploiting the infrastructure of its customer's primary bank while ING retains the deposit. In a December 2003 article with *ABA Banking Journal*, ING's Executive Vice-President of its US operation admitted that the absence of a chequing account is a factor in ING being "highly profitable"³⁶. PC Financial offers chequing accounts but is backed by CIBC's extensive back office infrastructure and ATM network.

The chequing account product is treated as the loss leader within the industry, theoretically enabling banks to establish customer relationships that allow them to cross-sell other more profitable products. Coast Capital Savings recent launch of a no-fee chequing account is a clear example of how aggressive the chequing account space is. TD Canada Trust recently launched a limited time free iPod giveaway when a client transfers over their chequing account from another institution and payroll deposit and/or pre-authorized debits. Although a full analysis would need to be completed, such cutthroat competition and Goldfarb research revealing that nearly 70% had never switched main financial institutions in the preceding five years, are signs that the bank's overall product and service offering requires a review for potential cost savings.

4.2.3 Parent Company Relationship and CB's Strategic Role

4.2.3.1 Strategic Fit with Parent

Given the growing levels of integration with its parent company yet divergent core business strategies—Vancity with its branch-based community and values-based orientation is clearly a differentiation based model, while Citizen's Bank virtual banking model is cost-based in nature, the question around the bank's strategic fit with Vancity's differentiation-oriented backbone

³⁶ "Tough-Love" bank thrives, Orla O'Sullivan, *ABA Banking Journal*, December 2003.

inevitably arises. While integration makes sense from a cost sharing and efficiency perspective, to successfully compete in the virtual banking space and offer a value proposition compelling to direct banking customers, the bank requires cost efficiencies beyond what it can achieve through its integration with Vancity alone primarily since Vancity does not orient itself around a cost-based strategy.

4.2.3.2 Overall Role of Citizens Bank within Vancity's Strategic Plan

Citizens Bank's role within Vancity's strategic plan appears to be as a growth vehicle, allowing the credit union to participate in markets beyond BC borders and also enable Vancity to diversify its asset and revenue base. Presumably, possessing a federal bank charter also gives Vancity additional options in the future should significant changes to the industry structure take place, such as if domestic bank mergers finally receive government blessing and the potential opportunities for credit unions to pick up branches the major banks will be ordered to divest as part of merger conditions imposed by the Competition Tribunal.

4.2.4 Challenges in Increasing Retail Presence

Establishing an increased presence in the retail market without a leg-up from a well-known brand and luring customers from more established players requires significant investment in marketing and brand building. As noted by Parveen Bansal in *The Banker* in September of 2003, aggressive product-focused marketing was a key part of ING's entry strategy as a bank with zero footprint in a foreign country with an unknown name³⁷. In Italy, ING Direct spends on average

³⁷ ING takes low-cost route to expansion, Parveen Bansal, *The Banker*, September 3, 2003, page 177, accessed at: http://www.thebanker.com/news/fullstory.php/aid/502/ING_takes_low-cost_route_to_expansion.html, June 11, 2005.

four time the amount of non-Internet banks on marketing³⁸. The approach of partnering with an established brand name was adopted by both PC Financial and MBNA's affinity card strategy.

Although Citizens Bank can leverage Vancity's brand name and reputation within the BC Lower Mainland, Vancity's awareness is limited to a specific geographical are. As a national player, the bank subsequently has to start its brand building from scratch outside of the BC lower mainland.

An increased storefront presence represents another way to bolster brand image within key markets. Additional storefronts with prominent signage and continuing the bank's cashless model also represents another way to lower marketing costs. With only two storefronts, in Vancouver and Calgary, there is opportunity for additional retail location in an important eastern market such as the Greater Toronto Area.

³⁸ Web Banks Pay More to Stay Cheap, Sarah Spikes, Wall Street Journal (Eastern Edition), New York. N.Y., June 9, 2004, pg. 1

5 RECOMMENDATIONS

Externally, industry trends and overall dynamics are essentially forcing a cost-based strategy in the retail banking industry and particularly so within the branchless banking segment. The industry as a whole faces continuing commoditization with increasingly savvy consumers and also aggressive monoline and branchless new entrants with significantly lower costs than traditional banks that are able to attract customers from incumbents through highly competitive pricing. These and other industry dynamics point to a strong likelihood of further consolidation and increased foreign competition from well established players with extensive global operations.

Furthermore, as the branchless or direct banking segment of the overall retail banking market grows and moves into the mainstream, new customers are likely to be even more price sensitive than the so-called early adopters who likely valued being amongst the early group to take advantage of direct banking and its accompanying competitive rates.

Internally, the shift to a cost-based strategy at Citizens Bank would be anything but a smooth transition. With its branchless model, the bank has the façade of being a low cost provider to the retail banking public but behind the scenes, is a relatively high cost provider as measured by its efficiency ratio compared to the big banks, much less its virtual banking competitors. Culturally and politically within the organization, a cost-based strategy is viewed as being at odds with the member advocate attitudes towards service and employee-focused values upon which the Vancity group of companies was formed. These values and attitudes continue to be a significant source of corporate pride.

5.1 Differentiation: A viable alternative?

Due to the inherent challenges associated with pursuing a cost-based strategy, it is necessary to explore whether a differentiation strategy can be considered a viable strategic alternative for the bank. Compared to a cost-based strategy, a differentiation strategy is generally more expensive due to higher branding and advertising costs.

To follow a differentiation strategy, the approaches to differentiation first need to be defined. Aaker noted that while differentiation can be based on a variety of dimensions such as product line breadth, service, ingredients or components and design, differentiation originates primarily from a focus quality and/or strong branding³⁹. Further to the internal analysis of the bank, the two potential approaches would be service quality, or further developing the bank's brand image based on its commitment to corporate social responsibility and ethical values. As mentioned previously, the likelihood of being able to successfully differentiate the bank based on service levels or attitude will be challenging largely because service quality is easy to imitate.

Moreover, an important dimension of service is convenience and ease of access. Offering 24-hour banking via the Internet, automated telephone banking, ATM, or call centre is not unique to branchless banks. Traditional banks offer these self-service channels in addition to their extensive brick and mortar networks as part of a multi-channel offering that allows customers to choose how and when they would like to do their banking. Although self-service banking customers may associate physical branch visits with line-ups and limited hours, and thus use the physical branch infrequently, these same customers ironically can also place value in simply having the branch option available for the rare situations when speaking to a person face-to-face is critical (e.g., resolving an urgent service issue such as a replacement ATM card). Consequently, virtual banks can be perceived by customers as offering "less service" than their traditional banking counterparts.

³⁹ Developing Business Strategies, Sixth Edition, David A. Aaker, John Wiley & Sons, 2001.

Customers for the large part expect a sufficiently high level of customer service from their financial service provider as a given, rather than a value-added dimension that they are willing to pay for through higher fees or less competitive rates unless service levels substantially exceed mass market levels (e.g., private banking). From the bank's perspective, good service retains customers. Even cost-based financial services providers cannot ignore service standards and quality measures. For example, although ING Direct clearly follows a cost-based strategy, it still has internal service standards which specify that phone calls be picked up by a human being within 20 seconds, in addition to the highly competitive rates it offers⁴⁰.

Due to low likelihood of success with differentiation by service quality, the only remaining option for consideration is for the bank to differentiate itself upon its commitment to corporate social responsibility and ethical values. From an internal perspective, CSR differentiation is a strong fit with the corporate values and culture, the bank's credit union roots and history, and also the fact that the bank would be well supported by the expertise of Vancity's 10-person Sustainability team.

Unfortunately, differentiating the bank based on CSR is not without significant challenges. To the general public, CSR can represent anything from corporate philanthropic programs, and cause-related marketing that can be relatively short-term in nature (e.g., CIBC's support of breast cancer through its sponsorship of Run for the Cure) to a comprehensive company-wide program and overall ideals that foster the engagement of multiple stakeholders to initiate dialogue and the exchange of ideas. CSR at both Vancity and the Bank lean towards the latter on this spectrum, which is multi-dimensional and more difficult to succinctly communicate. Differentiation is already costly from a branding and advertising perspective, and communicating a complex and multi-

40 "Tough-Love" bank thrives, Orla O'Sullivan, ABA Banking Journal, December 2003.

faceted CSR message will further increase member acquisition costs due to the additional marketing investment required for awareness building and education.

There is also a question of whether CSR will be sufficiently compelling on its own to attract a large enough customer base from existing players. Since the branchless or direct banking segment already represents a subsection of the overall retail banking market, segmenting this market further by those who value social responsibility in their purchase decisions of financial products and services would narrow the potential market even more. While various research and polls have suggested that consumers believe companies should be responsible corporate citizens, the mainstream public has yet to put its money where its mouth is—as evidenced by the niche status CSR products still hold in general, particularly within the financial services industry. Even within the bank's current member base, which is relatively small compared to competitors, the percentage of survey respondents who ranked rates or fees as the top factor that influenced them to start using the bank was nearly double the percentage of those who ranked the bank's Ethical Policy as the top influencer. Given that the bank has historically focused on CSR and values in its branding, this suggests that most of those who are inclined towards CSR for their banking products are still likely to be price sensitive. With those valuing CSR as a primary factor such a niche market, it is questionable whether the bank can meet its acquisition target of 70,000 members (an increase of 50,000) by 2008.

5.2 Recommendation

The recommendation is for Citizens Bank to migrate to a cost-based strategy. In the short to medium term, a cost-based strategy is the best approach to achieve the member acquisition objectives set out in the five year plan given the competitive dynamics and better informed consumers who are open to dealing with multiple financial institutions. Despite the internal challenges on the infrastructure and cultural fronts, to ultimately be viable and successful in the long run, the bank needs to recognize the realities of the retail banking marketplace and future

outlook, particularly within the branchless banking space, and adapt to the changing needs of its external target market.

The branchless distribution model by default signals to the consumer that the primary value will be price-based since the organization can pass on cost savings derived from what is externally perceived to be a lower cost structure. This rationale for competitive pricing was highlighted prominently in ING Direct's initial advertising which educated the target market—a clever move on their part to force competitors within the direct or virtual banking space to compete on price, which is not sustainable in the long term for firms without a corresponding low cost structure.

5.2.1 Implementation Considerations

The implementation of a cost-based strategy includes considerations in three key areas: improvement of the bank's efficiency ratio, challenges concerning the bank's corporate culture, and finally, pull marketing.

5.2.1.1 Improve efficiency ratio

The bank needs to decrease its non-interest expenses relative to the revenue it earns by:

Increasing process automation: The bank should explore further systems integration that not only reduces and minimizes manual processes leading to errors and potential customer service issues, but also integration that is scalable to support the bank's future member growth. The key challenge in this area will be securing the investment outlay required to support these system upgrades. However, a case can be made to the parent company that it too can benefit with behind the scenes automation without negatively impacting service on the front lines. In fact, one could argue that process automation and increased efficiencies can bolster member satisfaction by delivering on their needs in a more effective manner. On the financial side, despite Vancity's

larger size and ability to spread its costs over a larger member base, the efficiency ratio of the Vancity group is still higher than the big banks.

Streamline product line/service offering: The bank's product offering is somewhat stuck in the middle in that the bank offers a significantly broader range of products than its virtual banking competitors (PC Financial and ING Direct) yet also a much narrower range compared to a traditional bank. For instance, Citizens Bank offers five different types of bank accounts while PC Financial and ING Direct each only offer one type of account. Even within the credit card category, PC Financial offers only one type of Mastercard while the bank offers five different Visa cards, each requiring its own ongoing administration and maintenance. The bank should be a secondary rather than a primary "full service" branchless bank, rather than striving to be all things to all people, when over 90% of those surveyed in the bank's current member base use multiple financial institutions including the big five banks, ING Direct, and PC Financial. The total product line needs to be streamlined based on the current and future needs of the target market while also balancing the costs of each product category.

A clear focus internally on the target market: Because branchless banking is not for everyone, it is critical to be clear internally on the target market and focus on best serving this target market profitably. The "member- advocate" service attitude can lead to bending over backwards for all customers rather than doing so on a targeted basis for profitable customers and those with high potential. To sharpen its focus on the target market, the bank should conduct profitability analyses of its current member base to understand the profitability dynamics at the member level.

5.2.1.2 Cultural Challenges

Migration to a cost-based strategy requires a corresponding shift in the bank's culture to support its business strategy. Due to the bank's credit union heritage, parent company ties, and negative

perceptions around the notion of a cost-based strategy, much resistance against this cultural shift is expected. To manage this resistance and make the transition as smooth as possible, change management efforts first need to address any misperceptions around a low-cost strategy. Companies following a low-cost strategy do not necessarily fit the stereotype of the lean and mean corporation that lacks employee or customer focus. Southwest Airlines, a US carrier founded in 1971, is a case in point. With a clear business strategy as a low-cost provider, Southwest has earned a profit every year of its existence other than the first year of operation and its market capitalization exceeds the combined market capitalization of the other US-based airlines⁴¹. According to a 2004 article by Gene Smith in **Measuring Business Excellence**, Southwest has created an environment of or culture of shared goals, shared knowledge and mutual respect between people and the various functions of the airline such as pilots, flight attendants, ticketing, operations, repair, maintenance, catering, cargo and baggage. Smith found that Southwest's average compensation, including base salary, fringe benefits, and profit sharing, is the highest in the US airline industry and in addition, Southwest possessed the best customer complaint record for any US airline for 12 consecutive years. In his listing of Southwest's sources of competitive cost advantages, Smith names job security and corporate culture alongside fiscal conservatism, and boarding and fare structure systems, amongst other factors. The Southwest example illustrates that change management efforts at Citizens Bank should emphasize efficiency and lower cost do not have to, nor should they be, achieved at the expense of commitment to employees and service to members.

Another means of dealing with resistance is to tie the cultural shift to the bank's roots and any existing initiatives to provide a sense of continuity and progression from the past. When Vancity made the decision to expand outside via BC using a branchless national arm, this strategy already had some key elements of a cost-based strategy. In addition, the bank is currently undergoing a shift in its culture from a service culture to one that emphasizes sales and service. Any means to link the sales and service program with the cost-based one will provide employees

⁴¹ An evaluation of the corporate culture of Southwest Airlines, Gene Smith. **Measuring Business Excellence**. Bradford: 2004. Vol. 8, Issue 4; pg. 26.

with a more transparent framework to absorb the changes, and hopefully reduce the overload of multiple initiatives.

Despite all of these efforts, it is important to note that a cultural transformation does not occur overnight and requires significant commitment from entire company, particularly the senior management team, throughout the transition period to be successful.

5.2.1.3 Pull-based Marketing

Since Citizens Bank is relatively unknown by the retail banking public and has limited ability to leverage the Vancity brand outside of BC, the bank would need to invest heavily in advertising to build awareness and recognition. While pull-oriented advertising would still be required with a cost-based strategy, such advertising would feature products at competitive prices.

5.3 Conclusion

In a final word on the Citizens Bank's strategy going forward, external factors, whether they be industry dynamics for retail banking as a whole and specifically, the branchless banking segment, the overall competitive landscape, or changing consumer trends, are clear indicators that a migration to a cost-based strategy is essential to the bank's ability to compete, if not its future survival within the sector. However, because of the bank's increasing integration with its parent company, it appears that the internal viability of a cost-based strategy at the parent company level will ultimately rest upon the role the bank plays within Vancity's overall strategic plan. Unfortunately, Citizens Bank's stated strategy as the "national branchless arm" of Vancity lacks sufficient clarity in defining the future direction of the bank. To develop a plan that can address both external and internal issues, the bank's fit and strategic role within the larger Vancity group must be more fully defined.

For the time being, the Citizens Bank subsidiary and its federal charter allow Vancity to participate in markets beyond the BC borders and also diversify its revenue and asset base geographically. In the future, given the strong likelihood of domestic bank mergers and the potential opportunity for credit unions to pick up any divested branches resulting from conditions placed by the Competition Tribunal, already possessing a federal bank charter and operating a bank, albeit on a small scale, gives Vancity a leg-up over its credit union competitors in building a national presence.

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