

**A STRATEGIC ANALYSIS  
OF THE PARTICIPATION OF CREDIT UNIONS  
IN THE SMALL BUSINESS FINANCING SECTOR**

by

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## **ABSTRACT**

This research project is a strategic analysis of a typical Canadian credit union's participation in the small business financing market. The project provides an overview of credit unions in Canada, setting the context for discussion about credit unions, the unique operating environment of a credit union and the latest financial and industry data of Canadian credit unions. The small business financial services industry in Canada is described to paint a detailed picture of the characteristics of the market. Factors currently impacting this industry are examined through Porter's Five Forces and consideration to the attractiveness of the industry follows.

The project then focuses on a value chain analysis for a typical credit union at both the firm and industry levels. It is at this point core competencies and key success factors for a credit union to successfully participate in the small business financing market are identified. A strategic fit analysis examines eight factors to determine whether a differentiation or low-cost strategy would best fit the operating environment of a typical Canadian credit union.

At this point, the project's focus turns to identifying which segments of the small business industry a credit union should compete in and how it should compete. The small business market is segmented into three distinct groups and an analysis narrows the focus to one specific segment based on the characteristics and financial service needs of that segment as it fits with a credit union. A number of strategic alternatives on how to compete are discussed and are consistent with the generic strategy of a credit union. The project concludes with recommendations for implementation of a small business financial services strategy.

## **DEDICATION**

To my parents, Dave and Brenda Bolton.

Your lifelong encouragement and support has made this possible.

## **ACKNOWLEDGEMENTS**

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# 1 CREDIT UNIONS AND THE SMALL BUSINESS FINANCING INDUSTRY

## 1.1 Overview of Canadian Credit Unions

The Government of Canada defines a credit union as “a co-operative financial institution that is owned by its members and operates for their benefit.”<sup>1</sup> Ownership and corporate governance are based upon co-operative principles where the general requirement is to reinvest membership funds. Only ten members are required to form a credit union and each member, regardless of the credit union size or the member’s financial holdings, has one vote. The fundamental principle of operating a credit union is the provision of services to members. The credit union movement in Canada plays a large role in local economic and social development by reinvesting profits back into local communities. This philosophy supports the development of a small business strategy. Increasing ease and accessibility to financing stimulates small business growth, which, in turn, increases employment and services in local regions.

Today there are 1298 credit unions and caisses populaires<sup>2</sup> in Canada. Collectively, Canadian credit unions serve over 10.5 million members and have \$154 billion assets under management. Employment by the credit union sector has grown from 41,000 employees in 1991 to about 61,000 in 2001.<sup>3</sup> Canada has the world’s highest per capita membership with a distribution network of over 1700 branches. The following table outlines the financial data for the credit union system in Canada. (Source: Credit Union Central of Canada)

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<sup>1</sup> (Department of Finance, 2003)

<sup>2</sup> Each caisse populaire is a member of the Fédération des caisses Desjardins du Québec, a support organization responsible for the general orientation, planning, co-ordination and supervision of all activities of the Mouvement des caisses Desjardins. The structure of the caisses populaires is somewhat more centralized than that of credit unions and they operate under a single brand name. For the purpose of this paper, the unique features of the caisse populaire are excluded and only credit unions are considered.

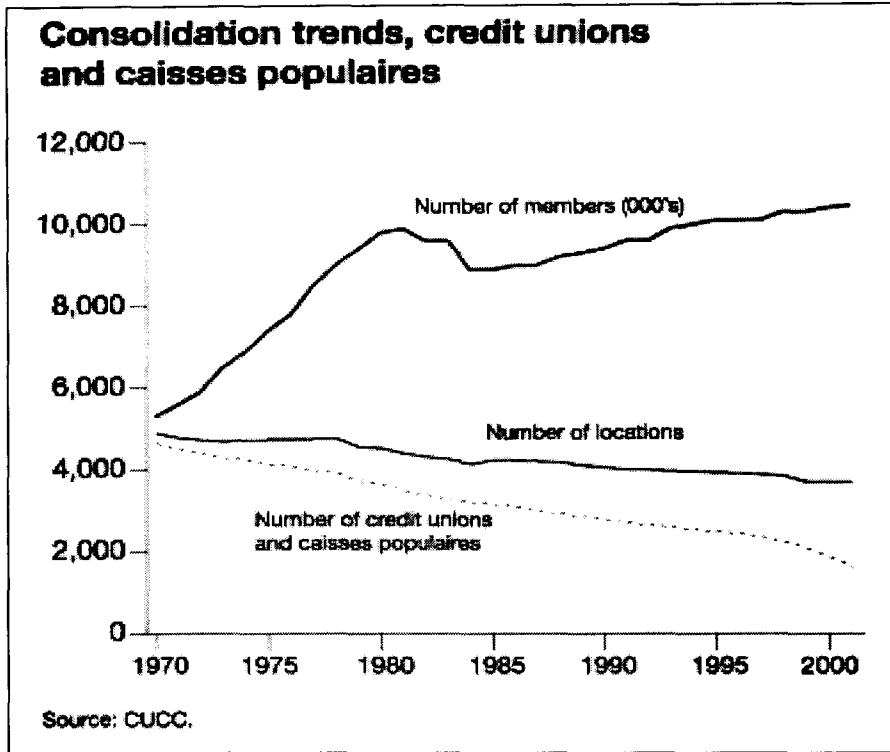
<sup>3</sup> (Department of Finance, 2003)

**Table 1: Fourth Quarter 2003 Credit Union/Caisse Populaire Financial Results**

<b>Province</b>	<b>Total Deposits (Millions)</b>	<b>Total Loans (Millions)</b>	<b>Total Assets (Millions)</b>	<b>Total Credit Unions</b>	<b>Total Locations</b>	<b>Total Members</b>
<b>BC</b>	\$26,315	\$23,850	\$29,039	51	339	1,490,906
<b>AB</b>	8,149	7,456	9,031	67	201	586,000
<b>SK</b>	7,752	6,348	8,632	120	332	550,097
<b>MB</b>	8,110	7,194	8,814	64	204	520,146
<b>ON</b>	18,538	14,643	20,525	245	692	1,561,525
<b>NB</b>	2,498	2,234	2,829	58	126	311,651
<b>NS</b>	1,156	899	1,254	37	84	168,832
<b>PEI</b>	516	431	565	10	15	62,356
<b>NFLD</b>	430	359	452	15	42	42,055
<b>QB</b>	59,791	58,995	72,533	608	1,506	5,162,662
<b>TOTALS</b>	133,920	122,974	154,410	1,298	3,567	10,526,827

There has been a trend toward consolidation within the financial services sector and that remains true for the credit unions as well. (See Figure 1) While the total number of distribution points (branches) has remained relatively the same, the number of credit unions has dropped from 2,700 in 1990 to 1,298 in 2003. Because of this amalgamation, the average size of a credit union has increased – most notably in Western Canada and Ontario. See Appendix B for a list of the largest 100 credit unions by asset size as of December 2003.

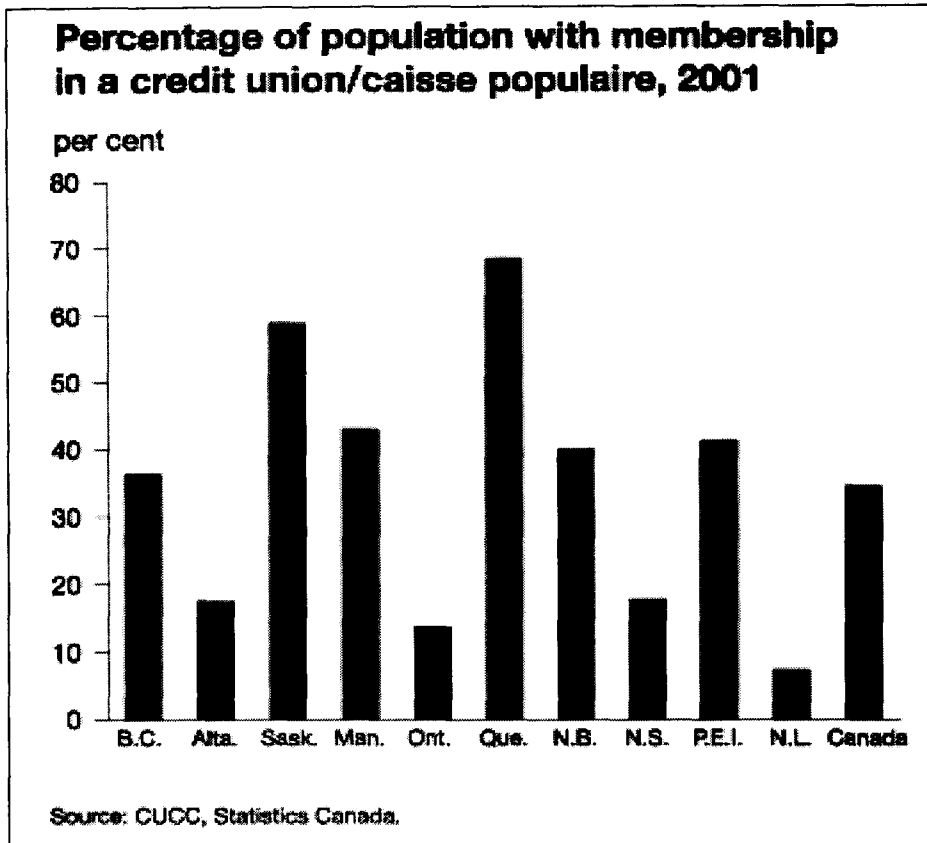
Figure 1: Consolidation trends, credit unions and caisses populaires



The size and impact of Canada's credit union sector can be measured by the number of distribution points (branches) and the number of members. A popular way in which the credit unions are growing is through acquisition of bank branches. In an effort to grow while adhering to a philosophy of ensuring all Canadians have access to financial services, credit unions are focusing on isolated areas. In 2001, across 6 provinces, 72 bank branches were purchased in communities that some of the six largest banks in Canada chose to vacate.

Increasing membership is another way to measure credit union size. Approximately 33 percent of Canada's population (or about 10 million) belongs to a credit union, which has grown from about one million members in 1950. As Figure 2 illustrates, Quebec has the highest percentage of credit union membership at approximately 70%, while Saskatchewan is second at 59%.

Figure 2: Percentage of population with membership in a credit union/caisse populaire 2001



## 1.2 Financial Data of Credit Unions

As per Table 1 (page 2), credit unions combined for a total of \$154 billion in assets, which is just over 10% of all of Canada's deposit taking financial institutions. The share of total credit union activity is highly variable across the regions. British Columbia's credit unions hold 40% of the credit union sectors assets outside of Quebec and have four credit unions in the top ten largest credit unions by asset size (excluding Quebec).

Most credit unions in Canada offer a full range of products and services – serving both individual and business memberships. The degree of development of the business products and services varies from credit union to credit union and can be divided into deposit, credit and value added products and services.

Credit unions capture the greatest percentage of market share in the areas of consumer credit, residential mortgages and deposits. Residential mortgage loans continue to be the largest component of credit union assets accounting for 44.5%. Commercial loans contribute about 20% to the overall make-up of the asset portfolio. Unlike traditional Canadian banks, interest income drives the majority of credit union revenue. As interest rates fall, credit unions look for ways to increase their sources of non-interest income. A small business strategy could contribute greatly to this trend, as there is a greater opportunity to charge fees in small business financing compared to consumer financing.

The ability of the credit unions to earn profits is sensitive to economic growth and capital markets. Figure 3 and 4 on the preceding page illustrate how the spread between revenues and expenses for credit unions has tracked from 1990 to 2001. The sector was adversely affected during the economic downturn in the early 1990's, as well as in 1997 when capital markets weakened.<sup>4</sup> The return on equity for credit unions tends to be lower than in the banking sector. The ROE for credit unions averaged 8.2% over the 1993 – 2000 time periods. In 2001, the ROE decreased to 7.5% however, this was in line with the results observed overall in the financial services industry.<sup>5</sup>

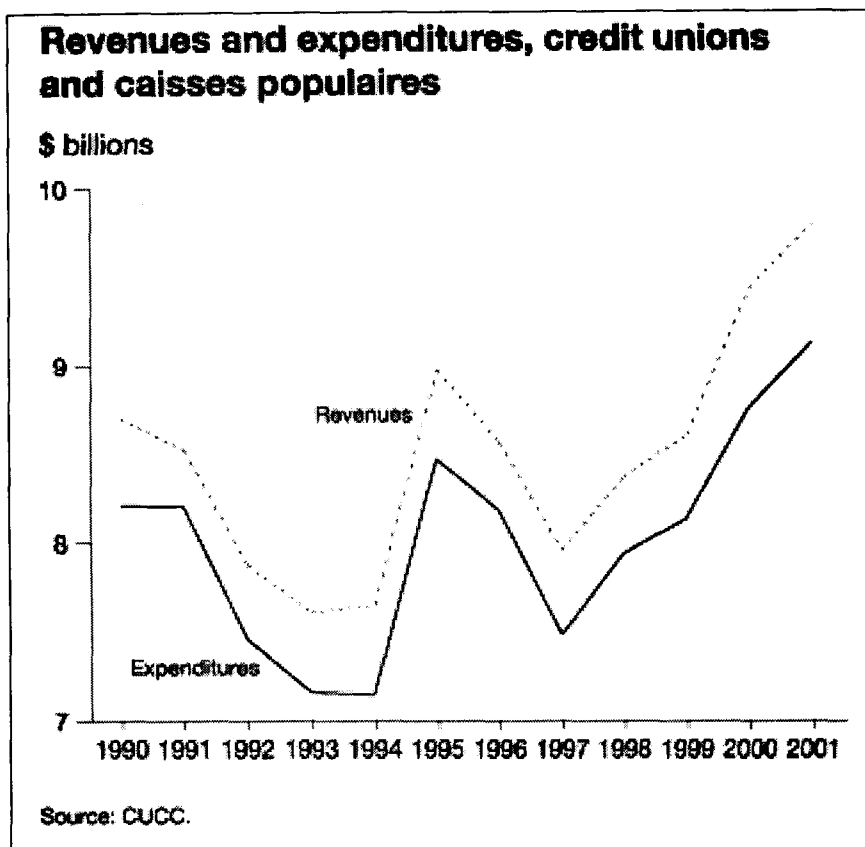
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<sup>4</sup> (Department of Finance, 2003)

<sup>5</sup> (Department of Finance, 2003)



Figure 3: Revenues and expenditures, credit unions and caisses populaires



The credit union system operates with a three-tier structure of local, provincial and national organizations. Local credit unions operate autonomously and are the primary shareholder members of provincial Centrals. The provincial Centrals are in turn the primary shareholder members of Credit Union Central of Canada that functions as the system's national trade association and services provider.<sup>6</sup>

All Credit unions are provincially incorporated and almost exclusively subject to provincial legislation. The purpose of the legislation is to ensure prudential soundness and market conduct.<sup>7</sup> This legislation is similar to the federal government framework that regulates the banks, and, in fact, the federal government does play a role in supervising the credit unions outside of Quebec. The federal government is able to provide liquidity support through the Bank

<sup>6</sup> (Credit Union Central of Canada, 2003, p. 1)

<sup>7</sup> (Department of Finance, Government of Canada, 2002)

of Canada and the Canada Deposit Insurance Corporation (CDIC). In addition, the national Credit Union Central of Canada (CUCC) is federally chartered and regulated.

The primary role of the CUCC, an association under the federal Cooperative Credit Associations Act, is to direct and supervise all activities of the nine provincial centrals and subsequently all Canadian credit unions. Canadian Central also acts as a voice to Government and other issues of national importance. The CUCC, or its provincial central members, often provides electronic payment systems or investments in shared system technology.

The financial services sector is regulated both provincially and federally, as outlined in the following table.

**Table 2: Regulation by Industry Sector**

<b>Institution</b>	<b>Regulator</b>	<b>Jurisdiction</b>
Chartered Bank	Office of Superintendent of Financial Institutions	Federal
Credit Union	Financial Institutions Commission	Provincial

There are significant differences in the regulatory requirements between banks and credit unions. For example, in Ontario, a credit union's loans cannot exceed 50 percent of its regulatory capital and deposits and the individual loan limit is 1.25 percent of its regulatory capital and deposits. Banks, under federal regulation, are provided much greater scope in this regard. Banks have different ownership regimes based on size and equity.

Foreign banks have the flexibility to choose among several different organizational structures depending on their strategic objectives in Canada. Options include operating by way of

a subsidiary of a foreign bank, a full service branch, credit-granting services only or any combination thereof.

### **1.3 Small Business Financial Services Industry**

There are various definitions of what constitutes a “small” business. Industry Canada categorizes businesses by number of employees while Export Development Canada uses revenues. For the purpose of this analysis, a small business will be defined using the Canadian Banking Association definition. A “small business” is deemed to have simple revolving or term financing requirements under \$250,000.<sup>8</sup> An example of a revolving facility would be a line of credit or credit card to finance working capital. A term facility would be a loan, advanced once, with fixed repayment terms of principal and interest, most often used to finance the purchase of fixed assets. In general, a small business entity will also have revenues of under \$5 million and fewer than 50 employees. Businesses outside these parameters tend to have complex needs that require customized products and service administered by a specialized and skilled account manager.

The most common types of credit offered to a small business by way of a financial institution are a line of credit, term loan and credit card. The line of credit typically operates via an overdraft on the borrower’s main operating account and is the most common type of financing for small business. Nearly three quarters of respondents (74.3%) in a survey by the CFIB<sup>9</sup> have a line of credit to finance their business operations. Term loans are used most often in the purchase of fixed assets and account for 37.4% of small business borrowings.<sup>10</sup> With the explosion of the reward travel market now available on almost every credit card, more small businesses are not only using business credit cards, but are also accepting credit cards when traditionally they would accept only cash or cheque. While accounting for only 21.4% of small business financing

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<sup>8</sup> (Canadian Banking Association, 2003)

<sup>9</sup> (Canadian Federation of Independent Business, 2003)

<sup>10</sup> (Canadian Federation of Independent Business, 2003)

according to the Survey, it is likely many small business owners finance business activities with their personal cards.<sup>11</sup>

The CFIB survey for 2003 also uncovered the following statistics on small business financing. The median size of a small business loan amongst all financial institutions is \$100,000 – an amount that has remained stable over the last few years. The average loan made by a credit union is significantly lower at \$65,000. The average cost of financing to the small business borrower is greater at credit unions than at chartered banks, where the average rate over prime is 1.58 for the former and 1.44 for the latter<sup>12</sup>. This difference in rates can be attributed to the size of firms that borrow. Generally, the smaller the business, the higher the cost of financing, and the Chartered Banks tend to have larger-sized small business clientele.

Small businesses also require products and services that support their deposit and cash management needs. These products are important to the discussion of small business financing because if a financial institution can support the clients' financing request and provide solutions for the other services a small business needs, it provides for an increased revenue opportunity for the institution, and a lower likelihood that the client will seek those services elsewhere. A chequing account with access to ATM's, telephone and Internet banking are important attributes to a small business in its relationship with its financial institution. Ancillary products such as creditor insurance, payroll, electronic funds transfer and merchant point-of-sale services can all be vital to doing business as a small business owner. The degree of involvement by the credit unions in this product area varies nationally, but for the most part, credit union offerings are not well developed, marketed or supported. Because these products are mostly fee based, development in this area would produce potential sources of non-interest revenue to credit unions provided the credit unions can be a competitive participant in the small business financing segment.

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<sup>11</sup> (Canadian Federation of Independent Business, 2003)

<sup>12</sup> (Canadian Federation of Independent Business, 2003)

The small business financing industry can be further divided into segments according to the North American Industry Classification System (NAICS) - an industry classification system developed by the statistical agencies of Canada, Mexico and the United States. The system is used for classifying establishments according to their primary activity. There are certain classifications within the population of small business that have unique financial requirements or create different levels of risk for financial institutions.

The first example is the professionals market. Loosely defined as doctors, dentists, chiropractors, engineers, lawyers and accountants, financial institutions typically view this segment of small business as less risky than, for example, construction companies or restaurants. This is because cash flow potential can be more accurately predicted. While this poses an opportunity for better risk management, over the years a precedent has been set to offer this customer segment discounted rates and fees, driving down the profitability of the relationship. Nevertheless, there are considerable opportunities to find profitable ways to service this market.

Another example of participants in small business segment with unique financial needs is businesses in the area of agriculture. This type of small business is an owner who works and lives in the same building, has irregular cash flow, receives government subsidies and relies heavily on factors out of his control (such as climate) to be successful. This is a highly asset-based lending segment, where cash flow is often unpredictable, so a financial institution must have flexible repayment options such as annual loan payments. The financial institution must understand the power of marketing boards and quotas. It requires a high degree of speciality, and that is the primary reason that some financial institutions choose not to service this market.

To best serve the small business segment profitability, a credit union must address two key questions: 1) which segments of the small business financing industry do we want to compete in?; 2) and how will we compete in those segments?

## **2 SMALL BUSINESS FINANCING INDUSTRY ANALYSIS**

### **2.1 Introduction**

This chapter will focus on an analysis of the small business financial services industry. As this is a small segment of the overall Canadian financial services industry, it is impossible not to consider the areas where the attributes may conflict with that of other segments. For example, in the discussion on homogenous products, retail banking products are identified as becoming commoditized but small business financial services are quite the opposite. Michael Porter's five forces will be used to examine the small business financial services industry in order to draw a conclusion about the overall financial attractiveness of competing in this industry<sup>13</sup>. Comments on the attributes of the small business financial services industry that materially differ from other aspects of retail financial services will be addressed as appropriate.

### **2.2 Rivalry among Competitors**

Rivalry amongst competitors in the small business financing industry is increasing. There is a high likelihood that rivalry will increase once various institutions determine a profitable product offering and distribution strategy for small business. The factors influencing the degree of rivalry are: 1) increased sales force in niche markets; 2) concentration of the financial services industry; 3) increasing industry growth; 4) homogenous products; and 5) high switching costs.

A typical credit union primarily competes against the major domestic banks (which include the five large domestic banks and several smaller ones as defined by the Office of the Superintendent of Financial Institutions) and other banks (including foreign banks, trust

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<sup>13</sup> (Porter, 1979)

companies and other deposit taking institutions) Secondary competitors include non-deposit taking organizations such as factoring companies, private mortgage holders and Crown Corporations such as the Business Development Corporation.

Niche players who specialize in single lines of business also contribute to increased rivalry. Examples of niche competitors in the small business financing industry are leasing companies and accounts receivable factoring companies. However the rivalry from niche players is reduced by the absence of economies of scope that occur when existing financial institutions have multiple business lines. Also, as it relates specifically to small businesses, by being able to offer only one product, the niche player is not able to build customer loyalty or full relationship solutions for the small business owner.

In discussing competition, credit unions as competitors of other credit unions should be addressed. For the most part across Canada, credit unions tend to service small, regional markets and are often the only credit union in a community serviced by banks and other financial service providers. As a result, it is uncommon for a credit union to compete directly with another credit union. There are exceptions to the rule that occur mostly in British Columbia, Ontario and Quebec. In these provinces, in major urban centres, there are often several credit unions in one area. Within these markets, there is a modified form of credit union. Specific strategies and information are not shared directly with other credit unions. However, in an attempt to gain additional scale economies, credit unions will often collaborate with one another on new technology or marketing initiatives through the local Credit Union Central. There is a general belief that overall credit union market share is small enough that there is sufficient business available to take from the other financial institutions. Credit union efforts are better concentrated focusing on these other competitors as opposed to each other. Because this paper is written from the perspective of a consultant advising the credit unions as a whole, credit unions will not be considered as competitors of each other.

### **2.2.1 Increased Sales Force in Niche Markets**

There has been an increase in aggressive sales forces in various niche markets of the financial services industry – both retail and commercial. Examples of niche sellers are leasing account executives, commercial mortgage brokers and factoring companies. ING is using a direct sales force to aggressively pursue investor commercial real estate in attempts to build market share, brand recognition and loyalty by specializing in only one aspect of financial services. Organizations previously regarded as partners in distribution are now competitors. The Business Development Bank used to be limited to term financing a small variety of assets for businesses. Often the chartered banks would partner on a financing proposal – each taking on proportionate risk. The banks did not see the BDC as a competitive threat because the product offering was very limited. Now, the BDC can offer a wide range of financial products and services and the banks regard the organization as a significant competitor in small business financing.

### **2.2.2 Concentration of Financial Services Industry**

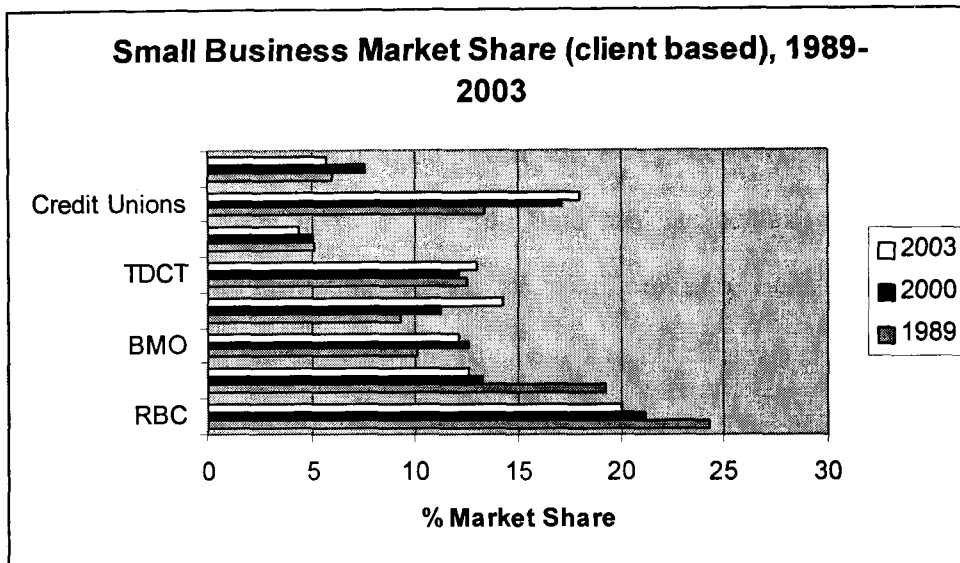
The high concentration of the financial services industry is one variable that decreases rivalry in this industry. In 2003, the five largest banks in Canada had 71.9% of the small business “market” (based on number of clients). The credit unions had 18% - up from 13.4% in 1989 and 17.1% in 2000.<sup>14</sup> Figure 4 illustrates the small business market share for three of the largest banks plus credit unions over the period 1989 to 2003. The two institutions with the largest market share (CIBC and RBC) continue to lose market share. Other than the Scotiabank, credit unions are the only providers increasing their small business market share. Regardless, with such high concentration, the result is that there are not many significant competitors competing with each other. As the number of competitors is reduced, the industry will behave more like an oligopoly with reduced rivalry.

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<sup>14</sup> (Canadian Federation of Independent Business, 2003)



Figure 4: Small Business Market Share (client based) 2003



### 2.2.3 Increasing Industry Growth

There are major differences in growth as it relates to small business and retail financial services. The retail banking market is experiencing slower growth which will increase rivalry amongst competitors. Canadian Bank's net interest margin (or spread) has declined by 3% per year over the last fifteen years. In 2002, five of the six banks saw net income decreases, including the first loss in history recorded for TD Bank. The retail banking market is a mature industry. When there is less business to be had in the marketplace, rivalry amongst competitors for retail banking services will increase.

Small business industry growth is the opposite. The rate at which small businesses are being formed and requiring credit is increasing. There were 2.41 million self-employed workers in the second quarter of 2003, an increase of 2.7% from the same quarter in 2002.<sup>15</sup> Total business loans outstanding from chartered banks amounted to \$97.3 billion in the second quarter of 2003, 1.6% higher than in the same quarter of 2002, when business loans under \$500,000

<sup>15</sup> (Canadian Federation of Independent Business, 2003)

accounted for 21% of the totals.<sup>16</sup> While the retail financial services market is a mature industry, the small business market is still relatively new.

#### **2.2.4 Corporate Similarities and Homogenous Products**

The current similarities amongst the major bank competitor's corporate structures and product offerings are increasing rivalry in the retail financial services industry. The top five banks are relatively similar in size and structure. There is no single price leader in the retail financial services industry. Each of the big players faces the same opportunities and challenges. A mortgage at one institution is hardly distinguishable from a mortgage at its rival. The more similar the dominant players in the industry, the greater the focus on cost structures to support price competition. This is a challenge financial institutions are facing as it specifically relates to mortgage and term deposit products. The banks used to believe a customer maintained a relationship with the institution at which a personal mortgage was held. This has turned out not to be the case. An individual can now arrange a mortgage completely through a broker and a lawyer and not have to revisit the bank where the mortgage is held until the term expires (most commonly five years). It is very easy for an individual to maintain a mortgage at one institution and a chequing account – which has daily activity – at a different institution.

The small business aspect of the financial services industry is quite different. First, the products and services available appear relatively homogenous on the surface. Customer demands make them distinguishable. A small business does not tend to hold a credit facility at one institution with a main chequing account at another. As part of the underwriting conditions, the financial institution, in more cases than not, requires the main operating account to accompany the credit facility. Secondly, small businesses are not as price sensitive as the retail consumer. A small business owner has the tendency not to move his or her business for a quarter percent of

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<sup>16</sup> (Canadian Federation of Independent Business, 2003)

interest if they are receiving a complete solutions arrangement.<sup>17</sup> Also, with the different small business segments, financial institutions attempt to design unique products and services to attract specific customers. For example, Scotiabank has a line-up of professional financing products and services that are unique in the industry. Scotiabank targets medical students while the students are still in school and deem high student loans and poor debt servicing ability as an acceptable present day risk for potential future success. Coast Capital Savings Credit Union has created a unique product also not available elsewhere in the industry. Disbursement funding is designed to target personal injury lawyers and provides financing levels leveraged against lawsuit account receivables. The program has been very successful and, at present, unduplicated.

As retail financial services grow more commoditized, the small business financial services sector is highly differentiated.

### **2.2.5 Switching Costs**

There is a difference in the switching costs between the retail and small business financial services. For the Canadian retail consumer, there has been a decline in switching costs. Financial institutions are cross subsidizing consumer business to grow market share, paying prepayment penalties on fixed loan products to grow volumes.

While some financial institutions will pay to bring over small business owner's financial services, the difference lies in the ease of switching. It is easier for a consumer to switch financial institutions than for a small business. Small businesses like to have all of their commercial dealings at one place. Plus, legislation is in place that allows lenders to insist on having the operating account at the same institution as the loan for risk mitigation – a condition that cannot be placed on the approval of consumer financial products because of tied selling

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<sup>17</sup> (BAI Banking Strategies, 1997)

legislation<sup>18</sup>. As a result, where a retail consumer can simply have a credit union transfer a mortgage and pick up the expenses associated with the transaction, a small business most often must move its operating account with the commercial credit, resulting in coordination of transferring other associated services such as supplier payments, point of sale transactions and payroll services. As a result, while financial institutions are attempting to make it easier to switch providers, small business will resist doing so.

## **2.3 Threat of Entry**

The threat of entry into the Canadian small business financing industry is currently moderate. Five to seven years ago, barriers to entry were high, and five to seven years from now, barriers will likely be lower than today. Factors influencing the threat of entry are: 1) regulatory policies; 2) technology innovations; 3) capital requirements; 4) economies of scale; 5) access to distribution channels and; 6) the likelihood of retaliation by incumbents.

### **2.3.1 Regulatory Policies**

Various provincial and federal governmental bodies heavily regulate the small business financing industry. While it will always remain heavily regulated, there has been a shift in policies making the industry easier for new entrants to penetrate. Historic barriers to entry have disappeared over the past 15 years. For example, a life insurance company can now own a bank, and a bank can own an investment dealer. This cross-ownership brings new, smaller and regional competitors to the market to compete directly with credit unions. The most dominant change in the regulatory environment of the industry was the creation of Bill C-8 which came into effect in October 2001. Bill C-8 has a number of measures that encourage new entrants. It has opened new opportunities for foreign banks to operate in Canada. In addition, the federal law now

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<sup>18</sup> Tied selling is a practice that imposes undue pressure, or coerces a person to obtain a product or service from a bank and any of its affiliates, as a condition for obtaining a loan or any other product from that same bank. (Source: Department of Finance, Government of Canada Glossary, 2004)

permits small banks to be owned 100% by an individual. For example, Canadian Tire has announced that it will create a subsidiary, Canadian Tire Bank. The law permits commercial companies to control small and medium-sized banks and facilitates access to the payment system so that life insurance companies and securities dealers can offer accounts and debit cards.

In the future, bank mergers and the Basel Accord are two regulatory issues that will have effects on the small business financing industry. A recent study by the CFIB provided recommendations and conclusions on the subject of bank mergers and their effect on small business. Based on their findings, the CFIB believes that the overall level of competition in the banking sector, as it relates to servicing small businesses, had not seen an increase over the years 2000 through 2003. The further consolidation of the industry could reduce competition.

The Basel Accord is set to come in 2007 and has three pillars. The World Council of Credit Unions Inc. (WOCCU) argues that the Basel Accord will result in a competitive disadvantage for credit unions. A study by the same group on credit unions in Australia & the US demonstrates that credit unions would receive little benefit from using the standardized approach of Basel, while larger financial institutions will gain a regulatory and competitive advantage. "Credit unions are built on cooperative principles, and pledge to offer local, affordable financial services," says Arthur Arnold, WOCCU's president and CEO. "WOCCU does not want to see these principles compromised."

### **2.3.2 Innovations in Technology**

Innovations in technology that are changing distribution methods increase the threat of entry to the small business financing industry in Canada. Canadians are early adopters of financial services' technology, and the Canadian small business financing industry has been quick to respond. From Internet banking to wireless Interac™, the growth of electronic financial transactions has been explosive. The adoption of new technology by small business owners

allows entrants such as ING or Wells Fargo to enter the market without investment in bricks and mortar. These institutions, and other foreign owned banks, are expanding the use of virtual banking. New entrants can leverage the existing financial services system to increase deposits or offer credit card products with little investment in tangible infrastructure. For example, Wells Fargo has created a successful direct mail credit card offering to Canadian small businesses with no financial statement requirements and quick turnaround time with its proprietary credit scoring technology.

### **2.3.3 High Costs and Capital Requirements**

If a new competitor wants to enter the industry without going virtual, there are very high costs and capital requirements. Provincial government regulations require minimum levels of reserves be maintained to back deposits, mandatory liquidity ratios and maximum commercial to retail loan ratios. To establish a physical branch network requires extensive investment in capital assets. Even the virtual banks attempting entry must invest in branding and advertising to establish loyalty with Canadian small businesses. Because financial services are a post-experience good, consumers will demand a sense of safety and trust. New entrants will incur high fixed costs to establish and develop this relationship.

### **2.3.4 Access to Channels of Distribution**

The access to the existing channels of distribution in the Canadian retail and small business financing industry makes entry relatively easy. There are two concrete examples of this concept. The Interac™ Association, founded by five Chartered Banks and utilized by the credit unions, is a national organization linking enterprises with proprietary networks so that communication for the purpose of exchanging electronic financial transactions can occur. As at May 2003, there were 110 member organizations. According to the Bank for International Settlements (BIS), Canada leads the world in both debit and Automated Banking Machine (ABM)

usage on a per capita basis. By becoming a member of Interac™, a new entrant can align itself with a well-trusted brand name in Canada and have national access to Canadian consumers and small business owners.

The second example is the establishment of web auctions that facilitate small business financing. The small business client describes its financing needs and allows various types of lenders to compete for the business. The institution hosting the website may not necessarily provide the financing but receives revenues from operating the site. While there has not been widespread adoption of this service, the access to distribution channels, coupled with technological advances, significantly reduce the cost of entry for a variety of outside financial services providers to compete in the small business lending market.

### **2.3.5 Strong Retaliation to New Entrants**

There is a high likelihood that new entrants to the Canadian retail or small business financing industry would be faced with strong retaliation from the existing institutions. Individual consumers and small business owners are becoming more sophisticated and access to financial information is readily available. Potential new entrants attempt to differentiate by providing seminars on small business, and tools and calculators on Websites, as well as sponsor small business initiatives such as trade shows or roundtable discussions. In response to this, several of the large banks have already taken steps to ensure they retain their existing customer base. For example, through RBC Financial Group's Internet banking service, clients can upload their accounts and liabilities held at competing institutions. The implication of this is that small business owners do not need to visit their secondary financial providers for account information but only have to go to the RBC website. Coast Capital Savings, Canada's second largest credit union, has partnered with Scotiabank to provide both Visa and MasterCard merchant services, instead of allowing new entrant First Data to provide this service exclusively. Simply entering the small business financial services industry may not be difficult for an organization with sufficient

financing, but the requirement for experienced management and the need for public confidence in the infrastructure, helps deter potential entrants.

The other deterrent to entrants in the small business financial services industry is the perception that the industry demands high touch and generates low profits. “High touch” refers to the frequency a small business owner requires contact from his or her branch. Small businesses manage cash flow daily and require more personal attention on a daily basis than a retail customer. Small business owners are heavy users of high cost channels such as the branches. Their deposits are large in terms of processing times, and they require non-revenue generating services such as coin supply. The small business is perceived as a higher credit risk due to unpredictable cash flows, and the projected result is higher loan write-offs. Later in this paper, I will provide arguments to the contrary and demonstrate how the small business customer has the potential to be more profitable than the retail customer.

## **2.4 Threat of Substitutes**

Although increasing, the threat of substitute products and services in the small business financing industry is low and limited. This is not the case for the retail financial services market which has a high threat of substitutes. Outside of the traditional three main credit facilities offered by most financial institutions: operating credit, term loan and business mortgage are substitutes such as receivable factoring, supplier credit and personal credit facilities. Contributing to the rise of substitutes are alternative distribution channels, the use of personal credit and increased access to the Canadian Payments Association.

### **2.4.1 Alternative Distribution Channels**

Financial institutions are attempting to mitigate the threat of substitutes by providing alternative and multi-channel distribution. In some cases, a small business can apply for a credit facility in branch, on the phone or over the Internet. While the distribution network is available,



it does not mean the client is receiving the proper advice or product offering. However, by increasing the choices of distribution, there is an increased likelihood a client will not leave for a competitive substitute – it just becomes a matter of arming the person (or voice or computer) on the other end with the proper skills and tools.

#### **2.4.2 Use of Personal Credit Products**

The use of personal credit products to finance small business growth increases the threat of substitutes to the industry. Many Canadians find it too cumbersome or difficult to attain small business financing. The rate of loan applications being rejected has been increasing. The overall loan rejection rate for the period 2000 to 2003 is 16 per cent, up from 10.5 per cent for the 1997 to 2000 period<sup>19</sup>. A Statistics Canada survey on small business financing found 20 per cent of small businesses did not have their credit applications approved in 2000 and 2001<sup>20</sup> (the most recent year government data are available). In the short term, the use of personal financial services is a substitute threat to a small business financial services strategy. In the long term, a small business cannot continue to use personal financial products and services without risk of accounting errors, lack of convenience, cumbersome recording tracking and inadequate banking facilities. For example, there is a limit to how much unsecured personal credit an individual can access. If the financial institution was able to evaluate the complete retail and commercial situation, the small business might be able to access additional credit. By only using personal products and services, the small business owner might stifle the growth of their small business.

#### **2.4.3 Access to the Canadian Payment Association**

Recent regulatory changes have granted non-traditional financial institutions access to the Canadian Payments Association (CPA). The end result is that life insurance firms, securities

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<sup>19</sup> (Canadian Federation of Independent Business, 2003, p. 13)

<sup>20</sup> (Canadian Federation of Independent Business, 2003, p. 13)

dealers and some mutual fund providers will also be able to offer demand accounts. Previously, access to the CPA was limited to federally and provincially regulated financial institutions.

## **2.5 Bargaining Power of Customers**

For the purpose of this discussion, buyers are considered small businesses and its owners. The power of this group is low because this group does not act collectively. It is unreasonable to think a group of financial institution customers would work together, for example, and all withdraw their funds from the institution at the same time. Bargaining power of customers is low for both small businesses and retail consumers.

To the benefit of the financial institutions, the more small business customers it attracts the greater its ability to be selective in the ones it wants to service. As a customer segment, financial institutions are forced to consider their varied needs and provide solutions to match those needs. The bargaining power of small businesses is not high because of lack of buyer concentration and the offering of bundled products.

### **2.5.1 Lack of Buyer Concentration**

The lack of buyer concentration at the individual and small business level contributes to low bargaining power. Small businesses are spread throughout the country – there are millions and they are fragmented. No one group of buyers has significant influence on product or price. The credit unions may be more dependent on a group of customers being regionally concentrated. With a more regionalized market, for example, one large commercial customer could exercise some bargaining power; however, this would be a rare occurrence.

### **2.5.2 Product Bundling**

Product bundling reduces the bargaining power of customers because it makes it more difficult for the customer to switch financial service suppliers. At present, product bundling is

very common in the retail financial services industry. Recognizing the commodity behaviour of most retail banking products and services, financial institutions are looking for ways to deepen the customer relationship. Research shows that the more products and services a customer has with a financial institution the less likely the customer will be to move his or her business. One solution is bundled product offerings. For example, Scotiabank has introduced the Scotia Total Equity Plan. A collateral mortgage is registered on a principal residence, cottage or rental property and the "one-time" application establishes an overall borrowing limit. The consumer then chooses a combination of Scotiabank products that best suit the customers needs – including small business financing under specified conditions. (For example a mortgage, line of credit and Visa) The rate is low and the flexibility is high. When the customer becomes so entrenched within the financial institution, switching costs start to rise.

Currently, there is little bundling occurring in the small business segment. Products and services are a la carte - the customer asks for what he or she needs for the small business. There is an opportunity to bundle for this market, based on the needs of the smaller segments within the broad category of small business. While bargaining power is currently low for customers, this strategy will combine meeting the needs of small business owners while increasing their affinity to the financial institution.

## **2.6 Bargaining Power of Suppliers**

There are hundreds of suppliers to this industry, and (overall) the power that suppliers exert is low. Both individuals and companies act as suppliers to small business financing. At the individual level, there is both sales/management and administrative labour – sales labour increasing the overall power of suppliers, while administrative labour does the opposite. Sales labour is mostly specialized; it requires higher education, licensing (i.e. mutual fund salespeople) or speciality training (i.e. the ability to analyze financial statements). In smaller markets where credit unions are usually located, the supply of specialized salespeople can be limited. For

example, a salesperson with a mutual fund license and chartered financial analyst certification would have bargaining power in smaller communities because these individuals are in limited supply. Administrative labour does not require special education and training, nor is work experience required. This is discussed further in the section on role of labour. Consumers also act as suppliers of deposits but do not act as a group and therefore exude little to no influence. Organizations that supply the industry range from IT providers to real estate owners (branch distribution) to joint ventures within the industry itself (Symcor). This group has little bargaining power because there are numerous suppliers in the industry and securing a financial institution as a customer or tenant is desirable for the supplier. Financial institutions are dependable as sources of payments to suppliers.

### **2.6.1 Role of the Small Business Owner**

Small businesses and their owners have the role of both buyer and supplier in this industry. As a supplier of capital, small businesses do not act collectively and therefore have little bargaining power.

### **2.6.2 Role of Labour**

Labour is a large supplier to the retail and small business financial services industry. The labour force in the industry consists of mostly salaried employees who can be categorized as sales and administrative. With the increased focus on providing quality small business advice, the industry has an increased demand for educated and qualified advisors. There is a low supply of individuals with professional designations. This demand increases the advisors bargaining power with the institutions. When quantity becomes scarce, the prices of supply will rise.

This effect is multiplied by the geographic diversity of Canada. In outlying communities, the supply of qualified account managers is much smaller than urban centres. Account manager turnover is one of the key frustrations that small business customers have with their institutions.

In a community such as Whitehorse, Yukon, for example, an individual from the community who has professional designations combined with an ability to leave the community will have strong bargaining power with the various financial institutions.

There is a large amount of low skilled labour required to run the operations side of Canadian financial institutions. Low skilled or administrative labour is most often found in back office functions such as credit and deposit administration and account processing. This type of labour requires minimal skills in most cases and is easy to replace giving little power to its suppliers. In addition, the majority of the workforce in the Canadian financial services industry is without union representation. The presence of a union workplace environment could increase the power of this group of suppliers; however there is no indication in the market of a trend in this direction.

### **2.6.3 Organizations as Suppliers**

The organizations that supply the industry also have varying levels of power. One of the largest suppliers is that of hardware or software – both commodities in the financial services industry. The level of power the supplier is able to exude is reflective of the size of the institution. Suppliers to chartered banks have less bargaining power, where suppliers to regional credit unions have more. For example, Coast Capital Savings Credit Union recently partnered with Desjardins to produce a Visa credit card. The Business Visa Coast Capital Savings is offering is not branded with Coast Capital Savings. Rather, it has Desjardins printed on the card. The reason for this is that the credit union did not have enough power to warrant Desjardins to create a plate to print Coast Capital on the Business Visa credit cards.

## **2.7 Overall Attractiveness of the Industry**

The purpose of discussing the five forces in the subsections above is to identify the overall financial attractiveness of the industry. The Canadian small business financial services

industry holds an opportunity for many industry participants – including the credit unions. The small business financing industry is an attractive market to enter for a financial institution. The main reasons the market is attractive are: 1) the number of small businesses is growing; 2) the non-homogenous nature of small business products and services; 3) high switching costs; 4) low level of substitutes and; 5) low bargaining power of customers and suppliers.

The number of small businesses being formed each year is increasing at a rate of 10%.<sup>21</sup> Twenty-five years ago, the small business sector accounted for roughly one-quarter of GDP. It now accounts for roughly half of GDP and over half of total employment in Canada. The retail banking industry is not experiencing this growth – it is flat and mature. The small business market offers a new customer segment for the financial institutions to enter that is complementary to the financial service provider's core business.

Retail banking products have become highly commoditized but small business products and services are still young and underdeveloped for the most part. This grants financial institutions the opportunity to charge varying prices and allows for differentiation amongst providers. In addition, the immaturity of the small business market is especially attractive to smaller, regional players (credit unions) because they can further segment and customize to the specific dynamics of their local markets.

A characteristic unique to small business owners is the blurred line between the owner's personal finances and business finances. While a large business owner is often characterized by a clear distinction, the line between a small business owner's personal assets and liabilities and business assets and liabilities is blurred. The current challenge of homogenous product offerings is that the major financial institutions are focusing on a product-approach and not a relationship approach. A product approach is not an attractive way to enter this market, because the leveraging of the full business and retail relationship is what makes the market profitable – not

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<sup>21</sup> (Building on Canada's Entrepreneurial Economy, 2003, p. 4)

just the credit facility. Because small business owners are looking for convenience and complete relationships, this is an attractive market for financial institutions.

Small business owners are reluctant to switch their business relationship from one financial institution to another. While retail customers tend to shop prices and are comfortable with a fragmented banking relationship, small business owners need their financial institution to have an understanding of the complete financial picture of their businesses. This is a desirable trait of the industry because it allows for greater share of wallet to the institution providing the financial services. An opportunity exists to charge a premium over market prices and to retain a customer base when the customer is not willing to switch very easily.

There is a low level of substitutes in the small business industry over the long term. On a short term basis, there are providers who offer speciality financing arrangements and small business owners who use personal financial products. However, over the long term, there are few substitutes for a complete relationship with a financial institution, as it will provide the small business owner with ease of access to services, convenience and accurate record keeping by offering the right product or service solution.

Finally, the generally low level of bargaining power that both customers and suppliers have contributes to the attractiveness of this industry.

While the retail financial services industry is highly rivalrous, the small business financial services rivalry has not yet reached the same level. With few potential new entrants, few substitutes, and low bargaining power of suppliers and customers, the industry appears attractive to incumbent financial services providers. The cost of entry, regulations and customer demand for security and safety of financial assets many make entry too costly for many new firms.

### 3 VALUE CHAIN ANALYSIS

#### 3.1 Introduction to Value Chain Analysis

Small business financing is a retailing and distribution business. The search for origins of competitive advantage in the value chain of different activities of the small business financing industry is a first step in analysing the key success factors<sup>22</sup>. The value chain and organizational competence are complementary because each offers an explanation of competitive advantage<sup>23</sup>. The aim of this chapter is to identify which resources and competencies best support the activities in the value chain to implement a profitable small business financing strategy.

The core of a value proposition is to offer consumers convenience, customisation and ease of access. The vital components of the small business financing industry value chain are fund raising, product and service development (insight), operations and processing, distribution and sales and after-sale service. (Figure 5)

**Figure 5: Small Business Financing Industry Value Chain**

Fund Raising	Product/Service Development (Insight)	Manufacturing	Operations & Processing	Distribution & Sales	After-Sale Service
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The industry value chain identifies key components where core competencies or competitive advantage can be obtained. Two prominent issues plague the small business financing industry: intense competition from new entrants with niche products (i.e. credit cards or receivable factoring), and the overall ability to deliver a business solution profitably. In order to

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<sup>22</sup> (Lamarque, 2003, p. 1)

<sup>23</sup> (Porter, 1985)



address these challenges the industry will likely see a reconfiguration of the value chain to include more outsourcing of non-core business functions, increased partnerships with third party suppliers, and more innovation in the profitable components.

## **3.2 Industry Level Value Chain**

### **3.2.1 Fund Raising**

Fund raising is the first key value activity of the chain. The credit unions raise funds from depositors to whom it pays interest at market rates. The depositors invest cash in various demand and term products that the credit union can then use to make loans. Banks also raise funds from capital markets by issuing different money market instruments and bonds. While depositor's funds are in transit between clearing points, the credit union has the benefit of float, which it uses in its daily activities.

### **3.2.2 Product and Service Development**

Product and service development is the next main activity along the value chain. This is the “insight” of the industry. In this context, insight encompasses activities such as product planning, business planning and market research. In the rapidly changing marketplace of small business financing, sustaining a competitive advantage requires more than just research and development – it requires the ability to be responsive and anticipatory. Small business financing requires servicing a customer segment with highly diversified needs. The ability to innovate at this stage of the value chain by delivering the desired business solution at the desired price that fully satisfies the consumer will differentiate the credit union.

### **3.2.3 Manufacturing**

Manufacturing in the small business financing industry involves generating and assembling the products that are developed from the previous stage. The ability to assemble a

strong product and service offering can typically be a core competency for a firm. The ability to properly anticipate the needs of the small business owner and bundle product and service offerings into a complete solution is key at this stage. This is a specialized competency that a credit union could customize to its geographic area and thus should not be outsourced. Collaborating with one of the provincial centrals could allow for synergies among the credit unions in creating the solutions.

### **3.2.4 Operations and Processing**

Operations and processing is the fulfilment side of small business financial services. This involves the ability of firms to carry out transactions and administrative tasks. There are three attributes of this component: support for customer facing staff, specialists who deal with complex processing or underwriting and the automated processing activities. The source of competitive advantage at this stage of the value chain is in underwriting processes and leveraging economies of scale. The level and complexity of underwriting required for a business loan varies with the size of the loan requested and the size of the company requesting the loan. If a financial institution is able to segment its customer base and apply specific underwriting procedures based on the needs of each segment, efficiencies are gained. Increased efficiencies have a positive impact on cost reductions, service level agreements and customer satisfaction. An industry example of using scale to achieve efficiencies is BC Central Credit Union. (BCCCU) BCCCU supports the collaboration of three credit unions in the production of a form of Internet banking for its business customers. Alone, no one credit union could afford or attain the required technical expertise, systems support or marketing assistance to launch such a business solution. Working together and using the resources of BCCCU allows them to accomplish this.

Credit scoring of small business is on the increase in the United States and just starting to enter the Canadian market. Currently, CIBC is the premier user of credit scoring offering unsecured small business credit up to \$100,000 within a few hours. The ability to credit score is a

critical success in the small business financing industry. This is a highly specialized task that should only be done in-house if scale and expertise permits. A bank may have the IT resources to dedicate to building a credit scoring solution; however, a typical credit union should look to buy a solution from a third party that has the expertise. The typical credit union does not have the information technology resources to build the competence in-house.

In April 2004, Credit Union Central of Canada announced that it signed a five-year agreement for credit risk management services with Covarity<sup>24</sup> – a real time loan monitoring, review and management product designed to help credit unions manage business accounts. It provides all credit unions with access to a technology that will automate and standardize commercial credit risk management. A national program makes it easier for credit unions of all sizes to increase efficiency in managing these types of lending portfolios.

### **3.2.5 Distribution and Sales**

Distribution and sales refers to the customer-facing activities in the small business financing industry. A customer facing activity encompasses any channel involving direct contact with a small business customer. This includes the branch, telephone, computer and Internet channels. Distribution covers all delivery channels and marketing functions. The greatest core competencies can be achieved by using customer relationship management (CRM) tools to understand customer needs. In the strategy section, there will be discussion of how the credit union has the opportunity to differentiate in this segment of the value chain by focusing on customer segments and full relationship solutions - not just products and services. The physical presence of a branch network will always be required, but by educating the small business owner to the alternative channels available, firms can build loyalty and deepen relationships.

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<sup>24</sup> (Credit Union Central of Canada, 2004, p. 1)

### **3.2.6 After-Sales Service**

The after-sales service function of the value chain concerns providing quality service after the consumer has acquired the products. It focuses on financial advice, support and consistency. The ability to fulfil the features of a product throughout the product life will help keep the customer loyal and potentially deepen the relationship. There is some room for outsourcing at the industry level, but it is more likely that any customer-facing activity will be kept in-house. One outsourcing activity currently in use at several credit unions is the measurement of customer satisfaction. Being able to measure customer satisfaction is a key success factor at this stage. Several credit unions, often coordinated through their provincial central, have retained the services of an outside firm to contact customers within 24 hours of conducting a transaction at a branch and ask them to complete a short telephone survey. These results are compiled monthly, and a score is given to the branch that then forms part of the branch's variable compensation. Branches adjust activities and centre coaching on improving this score. The immediate feedback helps the organization know what is working and the areas that require improvement.

### **3.3 Firm Level Value Chain**

A typical credit union has two types of core competencies – basic and distinctive. The basic competencies are broad in nature and are a footprint within the industry value chain. Some were discussed in the preceding paragraphs. The distinctive competencies are specific activities within that component of the value chain. It helps identify at which level value is added to the business solution and thus identifies origins of competitive advantage.

A typical credit union has core competencies in two basic categories: insight and distribution and sales. Competency in these activities ensures the credit unions have access to a wide variety of local small business market segments, that small business solutions are contributing significantly to the desired end result and that competitors have difficulty imitating

the credit unions. The firm level (a typical credit union) value chain is broken down into its key components and attached in Appendix A. The core competencies are identified in bold with the supporting key success factors identified at each stage. Examples of outsourcing and strategic alliances are also identified on the value chain.

### **3.3.1 Insight**

Insight is a basic competency for a typical credit union. Insight, for the purposes of this analysis, refers to a credit union's product planning, business planning, market segmentation and systems development. A typical credit union has a competitive advantage in two specific areas of this component: product planning and market segmentation.

Credit unions, on an individual basis, are small relative to their bank competitors. The second largest credit union in Canada has only 25,000 business customers.<sup>25</sup> Because of this, credit unions are better positioned to complete a more detailed needs analysis of its existing customer base for potential opportunities to deepen relationships. Credit union members are unique in that many hold an account at a local branch but also have a wide variety of products and services at a competing chartered bank. There is a perception that the credit union cannot handle additional business services required by the typical small business owner. Being small and local allows the credit unions to plan products and services that best suit its specific market. For example, the Estevan Credit Union in Saskatchewan would have a larger portion of agriculture clients than Island Savings Credit Union on Vancouver Island. Each credit union can product plan according to the needs of the greatest segment within its own small business community. Agriculture clients demand products and services that reflect seasonality or local market conditions. The larger financial institutions do not have this ability being national in scope and highly centralized; local bank autonomy does not exist. To adhere with consistent

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<sup>25</sup> (Coast Capital Savings, 2004)

delivery across the country, each bank branch must follow national direction, and the same products and services are offered in British Columbia as Ontario.

### **3.3.2 Distribution and Sales**

Distribution and sales covers all customer-facing activities including delivery channels, servicing, pricing, cross selling and marketing. The distinctive core competencies within this component of the value chain are a specialized branch network, business and retail financial expertise and the ability to leverage retail relationships.

While the number of credit unions has dropped from 2,700 in 1990 to 1,298 in 2003, the total number of distribution points has remained relatively the same.<sup>26</sup> Banks are accelerating consolidation of their branches and many have centralized any form of commercial services to major centres where decisions are not made at the local branch.<sup>27</sup> The ability to offer small business solutions at all points of distribution, coupled with local decision-making, is an advantage for the credit unions. The ability for a small business owner to conduct transactions at any branch drives deposit growth – the most profitable part of the small business relationship. Deposit growth subsequently drives cross selling opportunities and increases “face time” with the customer.

Credit unions are better positioned to handle a complete inter-branch banking service due to their smaller size and regional concentration. Credit unions can offer small business customers the option to carry out any financial transaction at any location. This is a more difficult competency for the bank competitors to imitate as it involves significant coordination at a national level plus a specific culture. The culture of regional support to local communities serviced by credit unions is more prevalent than in banks, as it forms part of its underlying philosophy of credit unions.

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<sup>26</sup> (Department of Finance, Government of Canada, 2003)

<sup>27</sup> (RBC Financial Group, 2004)

### **3.3.3 Support Activities**

Support activities are a vital part of the small business value chain. For the firm level value chain representing a typical credit union, there are four categories of support activities: infrastructure, risk and financial management, technology and human resources.

Infrastructure is the backbone of the typical credit union small business value chain. It is comprised of departments representing the various functions within a financial institution: lending, deposits, cash management, distribution and finance. Distribution is the branch network that each credit union owns plus call centres and other forms of technology designed to field customer enquiries (For example: telephone or online banking). Distribution consists of an integrated team that is focused on supporting distribution in the areas of sales, service and operational risk. The strategy of the small business lending and deposit departments is to make it easier for small business owners to access financial services and more profitable for credit unions to participate in this market. This department works to enhance the lending and card based delivery channels while constantly looking at ways to achieve synergies with other small business product and service areas. The finance group is responsible for the operation of core finance processes such as management, regulatory requirements, and statutory reporting to local and national centrals and provincial regulatory bodies.

Risk and financial management are key activities across all parts of the value chain. The ability to manage risk well has the potential to become a core competency for the typical credit union, and this will be addressed as an alternative in the strategy discussion as it relates to the application of credit scoring technology. The vision of risk management is to achieve excellence in risk management by contributing to the organization's overall goals, by providing quality service to stakeholders and by taking a risk-focused approach to investing resources. The guiding principal is to involve qualified risk professionals, partnering with local Central Credit Union Associations who are independent of the business units, in setting policies and defining risk

tolerance. Risk is evaluated across all levels of the value chain in five frameworks: enterprise risk, governance risk, strategic risk, liquidity risk and regulatory risk.

Technology is another support activity that must be incorporated along the entire value chain. Technology covers computing services, service management, solutions delivery and enterprise architecture. The competencies that the typical credit union has along the primary axis of the value chain cannot be carried out without a solid technology infrastructure to support them.

Human resources make up the final level of the firm-level value chain as it relates to support activities. Credit unions employ over 61,000 employees in Canada<sup>28</sup>; however, the average credit union employs only 37 employees. The key human resource activities are staffing, allocating resources, compensation, organizational design, measurement, employee services and training. The human resource department manages succession planning as well as internal and external recruitment. The ability to recruit and retain experienced small business specialists is key to entering this market. There is a level of expertise above that of a typical retail account manager.

### **3.4 Key Success Factors**

The ability to drive interest and non-interest revenue growth within a highly regulated and highly competitive framework is the key to success in the small business financing industry. There are a number of key success factors evidenced from the firm-level value chain. These key factors are product planning; streamlined credit decisioning and underwriting process; a customer relationship management (CRM) solution and employee expertise through the branch distribution network.

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<sup>28</sup> (Department of Finance, Government of Canada, 2003)



### **3.4.1 Product and Service Planning**

A key success factor for a credit union is its ability to create differentiated products and services that suit the requirements of the customer, while creating value for the organization. This requires the foresight to break down traditional product silos and take a more solutions based approach. The ability to customise products and services in an effective manner to serve the dynamic market segment is important. Products must address the core needs of customers, have easy to understand product features and simple and consistent pricing.

### **3.4.2 Streamlined Credit Decisioning and Underwriting**

A second key success factor to a credit union's operation is the ability to assess and underwrite credit requests in a manner that allows for adequate risk management and superior customer service. The credit facility is most often the product that brings the customer in the door. This could be a mortgage or a small business loan. The credit union must be able to assess the risk of the credit request very quickly. In this highly competitive industry, the turnaround on a customer decision must be very quick. At the same time, there must be sufficient due diligence performed to ensure risk measurement tools are in place.

### **3.4.3 Customer Relationship Management (CRM) Solution**

Data management and integrity is key to a successful CRM solution. Credit unions have a competitive advantage in this alternative because of the single repository of data that already exists. Banks have various systems and data warehouses, therefore the ability to extract data with integrity is more difficult. Because most credit unions are small enough to have a core processing unit, they have a better starting point to implement a CRM technology. This allows for better profit analysis across both the retail and commercial aspects of the customer's credit union relationship.

### **3.4.4 Qualified Sales People**

The final key success factor lies within the human resource function. It is critical the credit union employ individuals for the roles that interact directly with customers, who have strong sales skills combined with the formal educational training. The sales skills are critical as the ability to build affinity with customers is often tied to the number of products they hold with any particular financial institution. Technical skills or professional designations are no longer sufficient. The sales staff in the branches must not be product-experts but conversation-experts. The credit union must retain people who are comfortable asking questions and investigating further into customers needs.

The ability to realign technology and people to achieve profitable entry into the small business market will further strengthen the credit unions hold on these clients and promote organic growth via increased retail and commercial product and service penetration.

## **4 STRATEGIC FIT**

### **4.1 Determining a Generic Strategy**

A typical Canadian credit union is a consistent fit with the variables attributed to a differentiation strategy. Banks, the major competitors to credit unions in the small business financing industry, typically follow a low cost strategy. The generic strategy of a credit union is evaluated against eight variables to determine its best fit<sup>29</sup>. For this level of analysis, a “typical Canadian credit union” was the subject with consideration given to how it would apply to an entry strategy into the self-employed small business market.

#### **4.1.1 Differentiation Strategy**

To follow a differentiation strategy, the product or service must include unique attributes that are valued by the customer, and the customer must see it as different from the current offering of competitors. The perceived value allows the credit union to charge a premium price in exchange for that value. Credit unions, because of their smaller size and geographic concentration, are able to provide specialized products and services to the market that are specific the characteristics of that market. A credit union does not have to spread branding, resources or distribution across provincial borders. For example, the Sunshine Coast Credit Union, located in British Columbia, has 3 locations and is ranked 74th on the list of the Largest 100 credit unions in Canada by Asset Size (Appendix B). In considering a small business portfolio, the credit union does not have to spread its risk over a dozen industries. It knows the community intimately and offers financial product and service solutions that are flexible to the needs of the community.

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<sup>29</sup> (Bukszar, 2004)

### **4.1.2 Structure**

The structure of a typical Canadian credit union supports a differentiated strategy. Credit unions are highly decentralized with much authority delegated to individual branch locations. Although provincial and national “central” credit unions exist, the role of these organizations is strictly support. Each credit union is independent of the next. Credit unions are governed by a Board of Directors, that are elected by giving each credit union member one vote. Because of this, the make-up of the Board reflects the direction the members want to see the credit union head towards. The main competitors of the credit union in the small business market are the banks, which have a very centralized structure. The chartered banks tend to have large head offices where all decision making takes place. For example, at TD Canada Trust there are no longer any lending approval limits in the branches. All retail and small business credit decisions are forwarded to a call centre in either Edmonton, Alberta or Markham, Ontario for review and approval or decline. This type of centralized structure is more consistent with a low cost strategy.

### **4.1.3 Decision Making**

The decision making process at the typical credit union allows for significant autonomy which is consistent with the decentralized structure discussed in the preceding paragraph. There is a high degree of autonomy within the credit union framework and this supports a differentiation strategy. Decision-making is done locally, so risk management strategies can be organization-wide but reflective of local market conditions. Because of the focus on participation in local communities, decision-making is decentralized to allow branches to customize as necessary to support the make-up of their respective communities.

### **4.1.4 Manufacturing**

The manufacturing component of the strategic fit analysis refers to the ability to create economies of scale or scope. In Canada, the financial services industry in which the credit unions

operate is highly concentrated with large banks. The five largest banks in Canada operate with significant economies of scale with the ability to spread fixed costs over a national suite of products and services. This is consistent with a low cost strategy. Banks produce through scale in centralized units that make all decisions. Credit unions, on the other hand, do not enjoy the same level of economies of scale. A typical credit union operates with economies of scope and flexibility.

Economies of scope exist when a firm achieves cost savings by expanding the variety of goods or services. As a result, it becomes more cost effective to add another product to an existing product line than to produce the new product or service on a stand alone basis. These economies of scope occur at the credit unions by leveraging core competencies and cost complementarities. This is consistent with servicing the self-employed small business market segment because the credit union does not have to create a new set of commercial products and services (as it would have to do if it targeted a SME or mid-market segment) where it has little expertise or experience. Rather, because it is consistent with the characteristics of the self-employed small business segment, the credit union can leverage its competencies in servicing the retail market. It can take a retail approach to servicing this market with products, services, credit underwriting etc.

#### **4.1.5 Labour**

Labour within a credit union can be categorized into two broad areas: administration and sales. Labour within the administration category can be classified as non-customer facing. Examples of non-customer facing activities are back office processing, human resources or clearing. Sales roles involve interaction with a customer. Individuals that answer the phones for telephone banking or that service customers in branches fill customer-facing or sales positions. The sales positions within the credit union are skilled positions, consistent with a differentiation

strategy. To service retail clients, accreditation is required to sell certain investments or securities, and most often a post-secondary education is desired.

Even the simplest small business transaction demands a broader skill set than the average retail sales credit union employee would possess. A general understanding of the small business's financial statements, industry and organization structure is required for any transaction. There is a level of expertise needed to adequately uncover information and this demands an increased investment in human resources. While the credit union sales labour force is skilled, it will require additional skills to adequately service the self employed small business segment with a differentiation strategy.

#### **4.1.6 Marketing**

A typical credit union marketing approach is most closely aligned with a pull strategy. A pull strategy involves the organization using advertising and consumer promotion to induce consumers to ask the credit union for the products. Credit union members are very loyal to the cooperative philosophy – the generic credit union brand. Credit unions promote this image with slogans such as “People before profits”<sup>30</sup> A pull strategy is especially appropriate when there is high brand loyalty and high involvement in the category and people perceive differences between brands.<sup>31</sup> People see little difference between the five chartered banks and little difference amongst the credit unions. They do, however see a big difference between credit unions and banks. Marketing strategies for the credit unions are riskier and edgier than the traditional, more conservative bank marketing strategies, and this is consistent with a differentiated strategy. Richmond Savings, a former credit union in Richmond, BC, was famous for its “Humungous Bank” campaign that attacked the “Bank Heads” of its competitors. This campaign was so

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<sup>30</sup> Used by BC Central Credit Union

<sup>31</sup> (Kotler, 2001)

effective the banks eventually were successful in forcing Richmond Savings to stop running the advertisements.

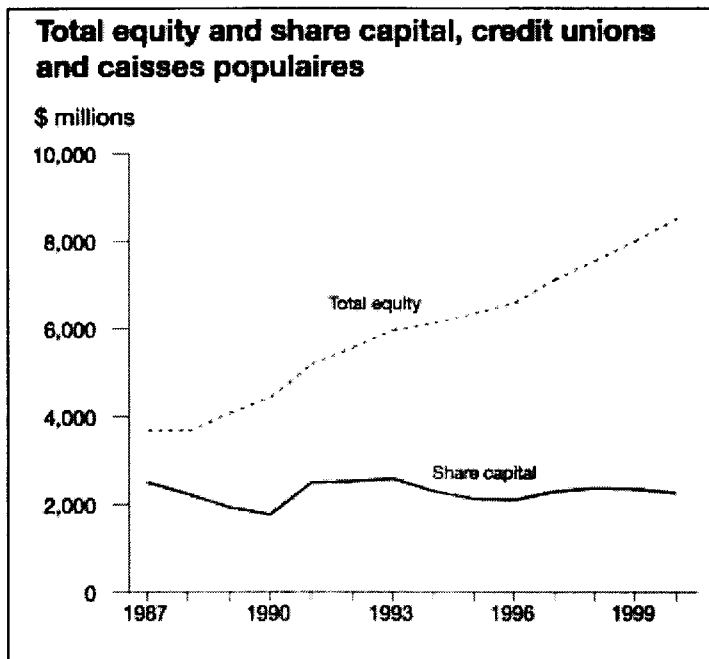
#### **4.1.7 Risk Profile**

Credit unions are a higher risk organization compared to Canadian chartered banks. This is due partially to the fragmentation within the industry –there are hundreds of small credit unions across the country. The Board of Directors is voted in by the membership – each member gets one vote. For some of the smaller credit unions, there is a greater risk of electing a board of directors whose views may represent a dominant section of the community, but not necessarily the most sound business intentions. The Canadian credit union system, however, is heavily regulated providing safeguards and corporate governance. Credit unions are bound by regulations put forth by provincial governments such as the Financial Institutions Commission (FICOM) in British Columbia. FICOM requires credit unions maintain certain liquidity and capital ratios that may restrict the type and amount of small business financing a credit union could participate in.

#### **4.1.8 Capital Structure**

Because the sector is so fragmented nationally, there are considerable differences in capitalization among the different credit unions. The growth of credit unions is financed by retained earnings rather than from share capital. Figure 8 demonstrates how over time more and more credit unions continue to use retained earnings to support growth. In some cases, this has led to imbalances within the credit union movement. While some institutions find it difficult to finance their rapid growth out of retained earnings, others find themselves with a surplus of capital.

Figure 6: Total equity and share capital, credit unions and caisses populaires



#### 4.1.9 Summary of a Differentiation Strategy and Credit Unions

Based on the nine characteristics, the credit union has a strong fit with a differentiation strategy for competing in the self-employed small business market. The credit union already has a strong personal membership base based on its cooperative philosophy – a differentiating factor amongst its financial institution competitors. A low-cost strategy is best left to the chartered banks that more closely represent an organizational fit with a generic strategy of this kind.

#### 4.2 Strengths and Weaknesses of a Credit Union

Based on the value chain and generic strategy analysis, the key success factors for the overall operation and differentiation of a credit union are product planning, credit underwriting, CRM solutions and retaining sales staff. These factors are also critical to the success within the small business financing sector of the financial services industry.



Credit unions have historically failed to acquire the expertise – human and technological – required to implement a small business strategy. Credit unions viewed the quality of small business portfolios as poor and the associated transaction costs and credit risk high with this book of business. Over the past five years, it has become more apparent that there is not only a lucrative economic opportunity, but that the support of the small business community is a philosophical fit with the credit union mantra. It promotes business development and creates employment in the local communities. Credit unions face some organizational challenges participating in this market but, overall, the small business financing industry is a strong strategic fit for a typical credit union.

## **4.2.1 Strengths of the Credit Union**

### **4.2.1.1 Geographic Concentration**

Credit unions across Canada tend to be geographically concentrated within provinces. For example, the Bulkley Valley Credit Union has three branches and is located only within the Bulkley Valley of northern British Columbia. The geographic concentration gives the credit union an advantage in knowledge and presence within the community. Part of the ability to manage small business credit risk well is intimate knowledge of local economic conditions. Unlike the banks, resources are not spread nationally in understanding the current state of each community. Rather, resources can be concentrated in one particular geographic area. Geographic concentration is also important to customer awareness. Often in many small towns, the credit union is the stable financial institution as the banks tend to move in and out of the smaller communities. People have an affinity towards the credit union and appreciate the smaller institution's commitment to local communities. This is a source of stability to small businesses looking for a banking relationship.

Geographic concentration is a strong fit with two of the key success factors. Product planning was identified as critical to the success of a small business financing proposition. Being geographically concentrated, the credit union is able to approach the small business financing market profitably in a highly focused and customized way. It does not have to consider the impact of product design decisions on other areas of the province or country. It can create a customized product and service offering and build brand awareness and consistency – something the banks could not do as easily. For example, a Saskatchewan credit union located in a farming community could design tailored small business credit to the cycles the farmers face and allow for flexibility in conjunction with local market conditions.

Geographic concentration is also a strong fit with the need for a competence in credit underwriting. Credit unions have a stronger tie to the communities in which they serve, than do the banks. Because of this, the credit union has a better understanding of the local economy and can design an underwriting policy that reflects this knowledge and connection.

#### **4.2.1.2 Local Decision Making**

Similar to geographic concentration, the local decision making done by the credit unions' Board of Directors allows for customization of products and services to the local markets. The ability to create products and services tailored to the needs of the small business owner was identified earlier as a key success factor in the credit union value chain. By having decisions made locally, a certain level of customization can be done that cannot be achieved by the national banks. For example, at TD Canada Trust, the creation of new products and services is done in Toronto, Ontario and then rolled out to all branches across Canada. A credit union has the ability to look to the local communities it services and segment its customer base in a much more focused way than the large banks.

Local decision making ensures the products being produced are customized and targeted to the focused geographic area that the credit union serves. The risk in small business credit underwriting is mitigated by the local knowledge of the individuals making the decisions or the inputs used in a credit scoring technology. There is more intimate knowledge available of the target market area. For example, TD Canada Trust does all small business underwriting for Western Canada at a centre in Edmonton, Alberta. In this instance, the local credit union in a fishing community on northern Vancouver Island, has the advantage of being within the community the client is living and working within. The underwriter in Edmonton likely does not share this same tacit knowledge.

#### **4.2.1.3 Corporate Size and Structure**

The corporate size and structure of a typical credit union is both a strength and a weakness in developing an entry strategy for the small business market. It is first discussed here as a strength. As mentioned in the second chapter, credit unions are typically small organizations relative to their banking competitors. The largest credit union in Canada has assets under management of just over \$6 billion – that is 1/10th the size of the Scotiabank, the smallest of the big five Canadian banks. Being smaller in size allows communication and decision making to happen more quickly. As an example, consider a small business product manager in Vancouver, British Columbia at a TD Canada Trust branch and a Coast Capital Savings Credit Union branch. At TD Canada Trust, all decisions are centralized in Toronto. Implementation of a sales campaign requires approval from multiple departments both locally and in Toronto. At Coast Capital Savings, all decision makers are in the same building as the product manager. Implementation of a sales campaign requires meeting with one person. The smaller corporate size and access to decision makers allows for faster implementation of business strategies.

#### **4.2.1.4 Retail Customer Service**

Customer service, listed as a strength for a typical credit union, could be argued to be a subjective attribute. As a highly fragmented, independently run group of financial institutions, it is difficult to accurately measure customer service across all credit unions. There are, however two reasons customer service is listed as a strength. First, the results of the independent survey conducted by the CFIB mentioned throughout this discussion validate customer service as a strength. Refer to Table 1 in Chapter One where credit unions were ranked first in categories such as “understanding of my business” and “treatment by account manager”. Second, because of the other strengths listed above, superior customer service becomes easier to provide.

Geographic concentration means credit union staff is more likely to become familiar with their clientele. In contrast, the CFIB survey data showed that the major banks are still not retaining account managers with their small business clientele long enough to continue to build on the client-bank relationship. Local decision-making allows the individuals who know the clients best to make the decisions. If decision-making is centralized, as it often is with the banks, the ability to know the personal characteristics of the customer is diminished. The cooperative philosophy and corporate size and structure give each member one vote and access to the decision makers such as the CEO or Board of Directors. The structure is much more transparent than a chartered bank. When the credit union staff knows that the customer has this access, staff is more likely to provide the higher level of customer service.

### **4.2.2 Weaknesses of the Credit Union**

#### **4.2.2.1 Current Provincial Legislation**

A challenge facing credit unions is the current legislation that prohibits expansion to another province. If a business owner moves to another province or expands his business operations outside of the provincial borders, the credit union loses that relationship. A bank, however, would be able to make a warm relationship transition to a local branch in the new

province. Because of this, retaining the relationship of a growing small business becomes difficult. Legislation also limits the amount of commercial holdings a credit union can have within its portfolio. In terms of growth, this can limit a credit union's participation in a customer acquisition strategy.

For example, currently Ontario's credit union legislation restricts the credit union's ability to make small business loans. The aggregate of outstanding small business loans cannot exceed fifty percent of the regulatory capital and deposits, or a lower amount as may be set by the Ontario Superintendent of Financial Institutions. The federal banking legislation and policy provides for much greater scope for small business lending.

The best opportunity for the credit union to remedy this challenge is currently before legislation – it consists of two parts. First, proposed in 2001, the Federal legislation would enable the credit union system, if it wishes to do so, to move from the current three tiered structure— local credit unions, provincial credit union centrals, and the national credit union central— to a two-tiered structure consisting of local credit unions and a national services entity. This could provide a mechanism for participating credit unions to take advantage of economies of scale, reduce costs, eliminate duplication and overlap, and promote stronger coordination with an enhanced national presence. To date, no initiatives from the credit union system involving the new provisions have been finalized.

The second part of the legislation specifically addresses the unique challenge that credit unions face; aiming to remain locally rooted financial institutions, but facing competition from national and global institutions. In addition to the new flexibility provided by Bill C-8 and the fact that credit unions are allowed to own banks and other federally regulated financial institutions, the possibility of establishing cooperatively owned banks is one option that has been suggested. The Government believes that certain key principles must underpin any cooperative bank model. These key principals are:

## Improving the cost structure of the credit union movement

- Accommodating inter-provincial and federal cooperation
- Measuring and taking into account the impact on the safety and soundness of the credit
- Respecting cooperative principles
- Creating consensus among stakeholders

In June of 2002, the Department of Finance announced that it would extend the comment period for its ongoing study of cooperative banking options until October 4, 2002 to ensure that all interested parties would have sufficient time to share their views. To date, there has been no further action taken on this consultation paper.

### **4.2.2.2 Historical Participation in the Market**

Since inception, the chartered banks have always offered commercial banking services. This provides these institutions with over 100 years of experience with commercial products and services. Historically, the credit unions have not participated in the business financing market, and even more so, have specifically avoided the small business financing market. The credit unions did not have the expertise to provide the level of analysis required to manage business relationships, therefore participation was limited to real estate asset financing. A credit union would approach a commercial financing opportunity as strictly transactional and provide credit as a percentage of the commercial real estate security – referred to as asset-based lending. This is reflective of the credit unions conservative lending policy and lack of knowledge of the subject matter.

To overcome a historical lack of participation in commercial financing, credit unions must work with the respective provincial centrals to pool resources – both human and technological. While participation is starting to increase at the relationship level, the recruiting of experienced individuals at the operational and strategic level will be key to success within this

industry. Competitive research in local credit union markets will help determine the desired level of participation and to what market segments attention should be directed. Through human resource recruitment, credit unions can target employed (or potentially contract retired) commercial bankers for insight and knowledge. The recent agreement with commercial risk management software provider Covarity is an example of investment into a leading edge tool to not only standardize risk management at the business financing level, but also to provide a strong support tool where there is historically not the human level of expertise.

#### **4.2.2.3 Corporate Size and Structure**

In the discussion on credit union strengths, the small corporate size and structure was identified as a benefit when it comes to having to make quick strategic changes within the marketplace. However, the small size of credit unions can also be a weakness. First, credit underwriting requires thresholds be set to identify risk tolerance in line with corporate objectives. With a small base to being with, the credit unions cannot afford a generous credit policy for the delinquencies that will accompany it. A larger competitor, however, has the capital base that can support higher levels of write-off. For example, Wells Fargo recently entered the Canadian small business financing market to provide a business credit card product. Wells Fargo uses the technology of Fair Isaac, one of the top credit scoring technology companies in North America, to create a mass mail offering to businesses. Because Wells Fargo is so large it can set a risk threshold higher than a credit union could afford to set. In addition, it has a small business portfolio large enough to validate different credit scorecards. Efficiency and competency in credit scoring and underwriting is an essential component to a small business strategy.

Because of the small size, it becomes difficult for the credit union to enjoy economies of scale and scope. There is less opportunity for cost sharing and skills transferring. Investment in the latest technology available is not usually affordable for the small credit union. There are

more manual processes present within the operations area of a credit union hindering the credit underwriting process and the ability to implement a CRM strategy.

This weakness is overcome with the ability of the credit union to draw upon the resources available from the Canadian Central Credit Union and the appropriate local central credit union. The ability of credit unions to share resources through provincial Centrals such as the Savings and Credit Unions of British Columbia, allows individual credit unions access to scale. These economies of scale usually occur in the process intensive or information intensive areas such as credit processing or back office administrative operations. The efficiencies give existing participants in the industry cost advantages over existing competitors and new entrants. Developments in information and communications technology, increases in processing speed, and decreasing costs of telecommunications allow credit unions to take advantage of shared costs and efficiency synergies.

#### **4.2.2.4 Ability to Manage Small Business Lending Risk**

Lending to small businesses carries a higher risk than consumer lending. Small businesses have high failure rates, unpredictable cash flows and can be more easily affected by market conditions. All financial institutions, not just credit unions, must manage these risks. Risk management is done through acquiring a higher level of expertise in both the people and technology that support small business financing. There are two weaknesses, specific to credit unions, which limit their ability to diversify credit risk.

The first type of risk is related to size. The typical Canadian credit union has not had the benefit of commercial loan portfolio diversification. As a financial institution grows in size, it mitigates risk by either growing the number of loans for the existing customer or from booking loans in different business sectors. These aspects of diversifiable risk that result from a credit



unions relatively small scale of operations are called idiosyncratic risk<sup>32</sup>. The second characteristic that will limit the ability to diversify risk is the geographic concentration of Canadian credit unions. This means small business members tend to be affected by the same market risk of local economic conditions. In contrast, the larger banks and financial institutions are spread over a wide geographic region and are not as vulnerable to local market risk.

There are three things a credit union can do to mitigate this small business lending risk. First, it can acquire knowledge in human resources. A prime requisite of moving into the small business financing industry is recruiting experienced lenders. Small business loans require a more intensive analysis on the front end and continuous monitoring. Small business specialists must have a thorough understanding of a potential borrower's annual reports, income tax returns and financial statements. Risk-based lending is more common in the small business sector than in the consumer lending sector<sup>33</sup>.

The credit union has the advantage of attracting experienced lenders who wish to stay in the local community. The CFIB survey indicated the most frustrating issue for a small business was account manager turnover.<sup>34</sup> With a smaller scale and limited geographic representation, the credit union can offer an experienced lender a more stable environment. Another advantage the credit unions have is the ability to tap into shared training resources through the credit union centrals. For example, CUSOURCE™ Credit Union Knowledge Network is the Canadian credit unions system's new learning organization. Working closely with credit unions and provincial centrals from across the country, CUSOURCE offers access to a full range of learning and knowledge sharing options. Just this year, it launched a new commercial lending program in partnership with Dalhousie University. Credit union commercial lenders can complete a interactive online program in commercial lending that leads to a commercial lending designation.

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<sup>32</sup> (Emmons, 2004)

<sup>33</sup> (Bankston, 1996)

<sup>34</sup> (CFIB, 2003)

The second way the credit union can mitigate small business lending risk is to maintain a focused and narrow scope on the businesses it wants to pursue. Aside from being small relative to the banks, credit unions have the advantage of specialization. The credit union can target its small business borrowers to reflect its community focus. For example, Evangelical Christian Credit Union (ECCU) makes loans mainly to churches, ministries and non-profit organizations<sup>35</sup>. ECCU's market is so specialized that it must underwrite its own commercial loans because banks and other institutions do not have standard statistical information to rate them (rather the banks would use more generic small business scorecards). ECCU developed the model internally because they know best what a church or school's financial statements should look like. Credit unions can be more aggressive in serving the business needs of existing members. For example, Teacher's credit unions could reach out to members who have summer businesses on the side. Credit unions should look to make small business loans where they know their members needs better than the banks. This is consistent with a focus on full relationship financial services

Finally, a credit union can reduce small business financing risk by growing its loan portfolio. A recent study by Federal Reserve Bank of St. Louis (2004) conducted research on the ability of credit unions or community banks to diversify risk through scale effects and geographic diversification<sup>36</sup>. The results showed that idiosyncratic risk dominates local market risk in small community financial institutions. All else equal, a community bank can reduce its small business lending risk significantly by increasing the number of loan customers in its portfolio. Local market risk is much smaller. The study concluded that the greatest risk-reduction benefits are achieved by increasing a community bank's size, even if it required an in-market merger. The advantage is that credit union's have greater leniency when it comes to merging with other financial service providers than the banks. A credit union could also increase its loan portfolio

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<sup>35</sup> (Bankston, 1996)

<sup>36</sup> (Emmons, 2004)

through loan participation agreements with other credit unions<sup>37</sup>. A loan participation agreement involves two or more credit unions sharing ownership of a loan or loan portfolio. A lead lender makes a loan to its borrower and then sells a participation in the loan to one or more participating lenders. This allows a credit union to increase its small business loan portfolio at a graduated rate and presents the opportunity to diversify loan risk.

A credit union faces unique risks associated with small business lending that its competitors may not always encounter. If a credit union wants to enter the small business financing market, it must develop competency in assessing and managing this risk. It can do this by recruiting experienced commercial lenders, utilizing training resources made available from credit union centrals, focusing on the members it knows best and growing the overall small business loan portfolio through in-market mergers or loan participation programs.

### **4.2.3 Market Potential**

While small businesses typically represent only ten percent of a financial institutions customer base, small business households represent disproportionately higher profitability. A small business relationship is four to ten times the average profitability of a retail household.<sup>38</sup> The ability to capture the entire small business owner's relationship can generate 50 to 70 percent of a retail network's total revenue.<sup>39</sup>

There is an opportunity to differentiate however, and it can occur in the presentation and distribution of products, and by providing value-added advice to complement the product and service offering of the small business owner – a relationship based solutions approach. Retail financial services are viewed as commodities and have little perceived value added. Small business financial services, however, are more specialized. This presents an advantage for the credit unions. Building off the preceding example of credit scoring, by being aware of local and

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<sup>37</sup> (Witt, 2002)

<sup>38</sup> (Miller, 2004, p. 3)

<sup>39</sup> (Miller, 2004, p. 3)

regional economic indicators, there is an opportunity for creation of a small business credit scoring system. Credit unions can set the attributes appropriate for the individual market. Doing so should allow for differentiation and cost efficiencies in writing the credit. Coupled with providing the value-added advice and relationship approach, this is an opportunity to successfully differentiate.

The increase in rejection rates could be a signal of an opportunity for the credit unions to step in and service this vital segment of the economy. Without financing, small businesses cannot contribute to the growth of the economy or create jobs. Increasing loan rejection rates could also signal that businesses are likely using personal resources to fund operations. Twenty four percent of small business financing is done using personal loans or mortgages<sup>40</sup>. A combination of lack of branch staff knowledge, lack of products and services and high loan rejection rates are pushing small businesses to retail financing products.

#### **4.2.3.1 Organizational Fit**

Overall, and despite potential weaknesses, participation in the small business financing industry with a differentiation strategy is a strong fit for a typical Canadian credit union. By investing in small business within local communities, the credit union is aligning itself to its cooperative philosophy by supporting economic development in local communities. The recent study by the Canadian Federation of Independent Business ranked credit unions first overall, against all over financial institutions. The weaknesses, as discussed above, are surmountable. Waiting upon legislation to allow for greater capital allocations and inter-provincial growth opportunities will not restrict a credit union from participating in small business financial services within its local markets. By concentrating on the small business market (credit requirements less than \$250,000), there is a good fit with the credit union's purpose of serving community needs,

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<sup>40</sup> (Canadian Federation of Independent Business, 2003)

and generally this segment carries less risk than targeting mid-market or larger corporate opportunities.

## **5 STRATEGIC ANALYSIS**

### **5.1 Introduction**

Based on the preceding discussion, participation in the small business financing market represents a business opportunity the typical credit union should pursue. The latter part of this paper will address which segments the credit union should focus on and the specific strategy it should employ to compete in the target segments.

The conclusion that a credit union should pursue entry into the small business financial services market is drawn from a thorough analysis of the small business financial services industry and its fit as an entry market for a typical Canadian credit union. An industry analysis using Porter's five forces summarized the growing market as attractive with low potential for new entrants, few substitutes, and low bargaining power of suppliers and customers. The strategic fit analysis concluded that a differentiation strategy was the best fit with a typical Canadian credit union.

The next step to implementing a profitable small business strategy involves deciding on the specific segments of the small business sector in which to compete. This means identifying a package of small business solutions that can be efficiently and effectively evaluated against predetermined and firm-specific risk tolerance levels, without the requirement of traditional commercial account management. The features and services the small business solutions will have will be determined by the key segment(s) the credit union will focus on. The segments can be geographically unique and identified by various attributes including: credit amounts, revenues, industry or product requirements. At the same time, credit unions must decide which segments it

will not compete in. In order to compete in a market with so many diverse competitors, credit unions must clearly identify the target segment(s).

## **5.2 Small Business Market Segmentation**

The small business financing market is highly diverse and customers have distinct needs and attitudes. Small businesses perceive value differently based on product attributes, service, price and distribution channel. The cost structure and profit potential to the credit union also vary amongst different segments within the small business industry. Table 3 divides the small business segment into three broad categories based on business attributes and financial services requirements.

To participate in small business financial services, the credit union must segment the market and not attempt to be all things to all small businesses. The credit union must determine what market to serve and how to serve that market, and also develop a competency-based strategy that addresses the needs of the segment being targeted.

**Table 3: Small Business Market Segmentation**

<b>Segment</b>	<b>Characteristics</b>	<b>Financial Services Requirements</b>
<p>Self-Employed Small Business</p>	<ul style="list-style-type: none"> <li>• Educated (work experienced or trade)</li> <li>• High mix personal &amp; business</li> <li>• Bookkeeper &amp; Quicken</li> </ul>	<ul style="list-style-type: none"> <li>• Deposit Services</li> <li>• Online Banking</li> <li>• Merchant Services</li> <li>• Business Loan or Line of Credit</li> <li>• Owner Personal Loans</li> </ul>
<p>Small &amp; Medium Enterprises (SME)</p>	<ul style="list-style-type: none"> <li>• Entrepreneurial to Professional</li> <li>• Medium mix of personal &amp; business</li> <li>• User of external professional services</li> </ul>	<ul style="list-style-type: none"> <li>• Low-level cash management</li> <li>• Payroll Services</li> <li>• Simple Employee Benefits</li> <li>• Business Loan or Line of Credit</li> <li>• Business Advisory Services</li> </ul>
<p>Mid-Market Business</p>	<ul style="list-style-type: none"> <li>• Entrepreneurial at a strategic level</li> <li>• Low mix of business &amp; personal</li> <li>• Professional designation in-house</li> </ul>	<ul style="list-style-type: none"> <li>• High Level Cash Management</li> <li>• Equipment Leasing</li> <li>• Expanded Wealth Management</li> <li>• Expanded Employee Benefits</li> <li>• Trust Services</li> </ul>



### **5.2.1 Self-Employed Small Business Segment**

The self-employed small business segment could also be called the micro-business or small-office home-office (SOHO) segment. “Self-employed” best describes this segment because usually there is no additional management staff to support the small business owner. The small business owner is the business and vice versa. Generally the business owner in the self-employed segment is educated via work experience or trade. An example of a small business owner in this segment could be an electrician who worked as an employee for a larger firm and then decided to start a venture of their own. Smaller scale professionals could also be grouped into this segment. A chiropractor or general practitioner’s office would be slotted into the self-employed segment. To illustrate the simplicity of this segment versus the SME or mid-market segments, it is easiest to look at the financial organization of the business.

Most of this segment operates as sole proprietors or a single shareholder corporations (possibly incorporated for taxation benefits), and the accounting system of choice is likely to be the services of a bookkeeper or personal accounting software. This segment likely sees an accountant once a year at tax time. Another key characteristic of this segment is the high mix of personal and business financial services. The line that separates the business owner’s personal finances from his or her business finances is not well defined. There tends to be a high use of personal financial services and products to finance the small business. A home office or one vehicle for personal and business use is not uncommon. Because this segment does not have a clear distinction between business and personal, ease of access and convenience are key attributes this group wants from its financial services provider.<sup>41</sup> More sophisticated services such as documentary letters of credit or payroll would not usually be required by small businesses in this segment. Businesses in this segment do not usually carry large deposit balances; rather these demand accounts have low balances and high transactions. This makes the accounts a good

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<sup>41</sup> (Molvig, 2004, pg. 4)

source of low cost deposits for the credit union because premium rates do not have to be paid. (Higher balance accounts demand higher interest rates).

This segment is the ideal target market for a small business entry strategy to a credit union. The details and reasoning will be discussed later in this chapter.

### **5.2.2 Small and Medium Enterprise (SME) Market Segment**

The small and medium enterprise (SME) market segment would be composed of customers with a more complex business structure. The owner of this business, while entrepreneurial, is less hands-on than in the self-employed market segment. This type of business would likely have a small management team to whom the owner could delegate business responsibilities. This business usually operates as an incorporated entity – often with several shareholders. An example of a customer type in this segment would be a multi-partner law firm. The law firm would have requirements for individual partnership buy-in loans, operating credit for the firm as a whole, credit facilities for certain legal disciplines (such as litigation) and ancillary services such as trust accounts and payroll services. There may not be a high mix of personal and commercial financial services. The partners will diversify some of their personal assets over several financial institutions.

The SME market is not a strong organizational fit with the credit union at this time. This market is a high touch market – it requires expertise in account management and a sophisticated suite of products and services. If the financial institution is not able to provide the entire solution, the customer's business becomes diluted amongst several institutions. This does not maximize the potential return on the relationship for any one institution. The SME market is also a segment where there is a high demand for accounts receivable factoring. These small businesses carry high levels of accounts receivable which puts pressure on the business's day-to-day cash flow. These companies tend not hold a significant amount of tangible assets, so the financial

institution is requested to lend a percentage of money based on the quality and timing of a list of accounts receivable. This type of lending requires review, margining and a level of expertise not available in the typical credit union. Without investment in technology or administrative assistance, this is a very time consuming product without the revenue offset.

### **5.2.3 Mid-Market Segment**

The mid-market small business segment represents businesses with complex financial services requirements. Typically, the business owners at this level are entrepreneurial at a strategic level. There is much less hands-on management of the day-to-day activities. Businesses in this segment often have a multi-level executive and a full Board of Directors. The owners tend not to mix personal and business financial services, preferring to diversify. There is a greater desire for separation, often for reasons of privacy or security. If credit facilities require personal guarantees, there could be occasion for a financial institution to look to personal deposits on-hand. By the owner keeping personal and business financial holdings separate, it prevents the financial institution from doing possibly taking from the personal assets to cover business obligations. While previous market segments have unsophisticated accounting software, it would be common for a mid-market client to retain professional services in-house with positions such as a Chief Financial Officer.

An example of a mid-market customer would be a large pulp mill with international customers and a staff of 50 people. There would be requirements for foreign exchange facilities, employee benefits programs, equipment leasing plus various credit facilities. A financial institution would require an account manager to develop an intimate relationship with the business, with regular site visits and monthly financial statement updates. This is a high contact customer who likely has all commercial dealings with one financial institution, but personal accounts across several other financial institutions.

The mid-market should not be a target segment at this time for the typical credit union. This market segment demands a high level of both sophisticated products and expertise. While this segment does not mix personal and commercial business, it does demand a full relationship with its financial institution. At this time, the majority of credit unions would not be able to service this market adequately. In addition, this market tends to carry large credit exposure which brings higher risk. The credit union does not have the volume to offset this risk, nor the risk management people or software.

### **5.3 Target Market Segment: Self-Employed Small Business**

Based on the segmentation in Table 3, the typical credit union should enter and focus on the self-employed small business market. For profitability and fit reasons, this is the ideal market segment for the credit union because of the high mix of business and personal financial services, the simplicity of commercial credit, the low cost deposits and the geographic limitations of the credit unions in Canada.

#### **5.3.1 High Mix of Personal and Business Financial Services**

The self-employed small business owner tends to mix personal assets and liabilities with business assets and liabilities. It is a market with a hybrid of business needs: retail characteristics across all sub-segments. Often start-up financing is obtained through personal savings, credit cards or equity in a primary residence. The office is usually based in the primary residence allowing for the deduction of several home-office based expenses under Canada Customs and Revenue rules. The typical credit union has the product and service line up plus the expertise to provide personal financial services. Because the business needs of this self-employed segment are simple, it would require little investment in marketing or human resources to increase the skill set of existing branch sales staff to be able to have intelligent conversations with the small business clients. By focusing on both the personal and business needs of the small business

owner, the opportunity to deepen the customer relationship and subsequently customer affinity increases. This would not be a viable approach to a mid-market client because the tendency is for these more established, larger businesses to keep personal and business finances very separate.

### **5.3.2 Simple Commercial Credit Requirements**

The self-employed small business has very simple commercial credit requirements. Credit is usually required in the form of an overdraft or credit card to help with day-to-day cash flow or small asset purchases. The majority of a credit decision lies in the strength of the personal covenant – not the business. These are often start-ups or home based, and accounting records are strictly done as CCRA requirements. Long-term assets often consist of leasehold improvements or shareholder's loans – assets that provide little financial value to a credit application. Focusing on this market allows the credit granting criteria to be based on retail credit policy. Attributes such as personal credit history, homeowner status, length of time as a customer, and personal net worth are often sufficient to evaluate a self-employed small business request. This addresses the challenge of a lack of expertise and commercial credit experience facing the credit unions.

### **5.3.3 Source of Low-Cost Deposits**

The self-employed small business segment also brings low cost deposits to the credit union which increases the profitability of the relationship. As described in Table Four, this market segment has a high need for deposit services (chequing account) and often a merchant services solution. Merchant services solutions are highly specialized, and there are several very large organizations that provide these services. This is not a product where a credit union needs to develop a competency and therefore should be outsourced to a third party. For example, VanCity, Canada's largest credit union, retains the services of Desjardins to provide the merchant solution.

The opportunity for low cost deposits is an important part of the overall profitability of the small business segment to credit unions. Credit unions have a challenge unlike the banks in terms of capital. As discussed in the section on regulatory environment, credit unions must maintain stricter capital ratios than chartered banks and are limited in the amount of funds they can lend out. They can “run out of money” to lend when capital ratios fall below minimum provincial regulations. Self-employed small businesses are good sources of deposits, specifically when tied to a merchant solution. The deposits are low cost compared to the SME or mid-market because the balances, on average, are not high enough to demand a premium interest rate to be paid on the chequing account. In most cases, the credit union does not pay interest on a business account with a small average balance. Once the balances reach the hundred thousand range, the customer demands a premium interest rate be paid, reducing the profitability of the account.

#### **5.3.4 Geographic Limitation of Credit Unions**

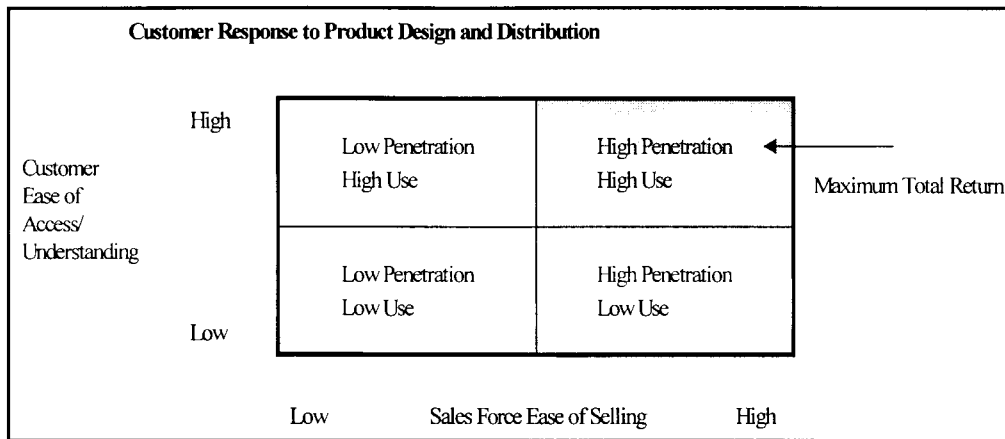
Discussed in the regulatory portion of this paper, credit unions are provincially regulated and restricted to doing business within the respective provincial geographic borders. Self-employed business owners are more likely to be regionally concentrated and not require intra-provincial, national or international financial services. The self-employed small business works from home or one location within a community. The SME or mid-market client is more likely to have multiple locations in multiple cities – possibly outside of a credit union’s defined market area. The chartered banks are already well equipped to handle national inter-branch banking, so the credit union should not try to compete on this strategy. Instead it should focus on meeting the needs of local businesses.

### **5.4 Differentiating in the Self-Employed Small Business Market**

Small business owners want easy, convenient solutions to business problems, and credit unions want highly efficient and easy-to-manage products and processes. The first step in

execution is to design product and service solutions that are convenient and easy to access for the small business owner while simultaneously being easy for the sales force to distribute. Figure 7<sup>42</sup> demonstrates that the maximum total return is present when there is high penetration and use of the credit union's products and services. While characteristics and pricing are important attributes, the small business owner still places importance on having a satisfying experience with its credit union.

**Figure 7: Customer Response to Product Design and Distribution**



If small business owners behave as retail consumers of products and services, they will make choices based on their own values and needs. The current homogenous product offering of a stand-alone Business Visa or Business Overdraft Protection may suit short term needs, but not over the long term. Small business financial services are unlike commodity products such as a residential mortgage or consumer loan. A bundled solutions approach is best for both the lending organization and the customer. This is because the small business receives the benefit of advice from an expert who is giving consideration to a complete financial situation. The organization receives the benefit of deepening the client relationship and the added revenues that accompany this approach. The economics of this segment improve measurably as small business owners add to the number of business and personal services they purchase. Through effective product

<sup>42</sup> (McClave, 2002, p. 7) Reprinted with permission from CCH Tax and Accounting Publishing

management, the credit union stands to gain a significant competitive advantage. The credit union can proactively designing products are customized to small business needs.

Banks try to lure small businesses through pricing, delivery characteristics, breadth of product line and institutional product branding, and the result is a proliferation of products with low penetration rates for all but the most traditional products – a loan and a bank account. A credit union should position itself as a differentiator - done by leveraging the strengths of organization. Credit union strengths were discussed earlier; however the key strengths for positioning are geographic concentration, local decision making and corporate size and structure. Product design that creates business and retail solutions combined with distribution tailored to customer channel preferences can transform “commodity products” into competitive advantage.

The key is the ability to provide broader product and service offerings while simultaneously lowering the unit cost per transaction. This is done by adopting a form of mass-customized approach. The “mass” portion of mass-customization involves basing the strategy on consumer finance – using credit scoring and risk management tools currently employed in the large retail market of financial services. The “customization” piece refers to broadening the current small business product and service offers to include retail financial products and services that are specific to needs of small business in the community the credit union services. The result is a deepening of the small business customer’s relationship with the financial institution. Through mass-customization, the unit cost per transaction is reduced, risk management improved and the ability to capture a greater share of wallet with the client is improved.

Product development starts with an assessment of the needs of the various target market segments within the self-employed small business market. These will likely be geographically unique to each credit union depending on its community dynamics. The needs assessment should be based on the lifestyles, values and financial management requirements. A base model should be created that addresses the core needs and sets the tone of the relationship plus locks in the



value for the customer and the credit union. The second piece to the product development should encompass a comprehensive solutions package that addresses the common needs of small business owners over four facets: managing the business, financing the business, staffing the business and operating the business.

There are three approaches a typical credit union could take when entering the self-employed small business segment as a differentiator: bundling, customer relationship management and community economic development.

#### **5.4.1 Small Business and Retail Bundling Products**

The more prominent way the credit union will differentiate in the self-employed small business market is by bundling commercial and retail solutions for the small business. A product solutions approach has a different perspective than the traditional product line management. It approaches design and distribution with a focus on creating solutions to small business owners commercial and retail financial needs. The banks, because of size and national scope discussed in the value chain chapter, focus more on repackaging and enhancing single product lines. Credit unions have the advantage of being able to customize business solutions by providing multi-product solutions to interrelate personal and retail opportunities whereas competitors are taking a single product approach targeted to narrow financial needs. For example, TD Canada Trust has an Ontario initiative in conjunction with the Provincial Government to offer small business loans up to \$15,000 at one percent under the prime-lending rate. The approach is to direct mail clients on a pre-qualified basis, and the entire credit facility can be fulfilled from over the phone. While meeting immediate customer needs, the bank is missing the opportunity to capitalize on the full business and retail requirements of that small business owner and is left with a small margin, one product penetration relationship.

The advantage the credit union has over the chartered banks is rooted in how the small business financial services are currently distributed. The largest share of the deposit market is typically held at the banks while the credit facilities are more fragmented among banks, finance companies, leasing companies, brokers and private investors. The credit facility is the most common lead-in to a customer acquisition. Self-employed small businesses are so burdened by cash flow, they will begin their relationship with the financial institution that solves their business credit requirements. By writing an offer that contains not only a credit solution, but a deposit solution (plus relationship opportunity for the retail business), the credit union can differentiate from the banks plus develop a profitable market segment.

One specific example is utilizing a personal mortgage for both business and personal liabilities. A credit union is not subject to the same rules as a chartered bank when it comes to registering a mortgage against a residence. The Bank Act limits chartered banks to registering an uninsured<sup>43</sup> collateral mortgage to 75% of the appraised value of the home. A credit union can register a mortgage for whatever value it deems appropriate – even greater than 100%. In this example, the assumption will be made that the local credit union has one branch in a small town with two other chartered banks and that on the news of a large commercial project coming to town, property values are increasing at a rate of 5%. The local credit union could launch a campaign that targets self-employed home owners who will be contracting for this large commercial project. It could offer a bundled multi-purpose mortgage option with the following attributes:

- Register the mortgage for 125% of market value;
- Transfer the personal mortgage of the self-employed business owner from the competing institution;

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<sup>43</sup> Uninsured refers to the mortgage not being underwritten by either Canadian Mortgage and Home Corporation (CMHC) or GE Capital - a requirement for high ratio (over 75% loan to value) mortgages granted by the chartered banks.

- Offer a second mortgage secured business line of credit at a fully secured rate to refinance any existing business debt;
- Upon proof of signed contract with large commercial project coming to town, offer no repayment for the first six months
- Complete the offering with a personal and business chequing account with no fee on the personal chequing account and a flat fee on the business chequing account.

The idea behind the no fee personal account is that the credit union could justify to the client charging a higher fee on the business account because the business account fee is tax deductible, while the personal account fee is not. The chartered banks could not compete with the higher ratio mortgage registration and the credit union is still well secured. By combining the business debt under mortgage security, the small business owner gets the benefit of a secured interest rate (lower than an unsecured rate). The credit union is mitigating risk by taking residential mortgage security in a market with rising house prices. Overall, it is a complete product and service offering that will increase a new or existing customer's share of wallet with the credit union.

This is a strong fit with the matrix in Figure 7 because of the ease of selling by the credit union sales staff and ease of understanding by small business owners. It is easy to sell because the product is based on a retail loans product. Retail lenders understand refinancing, transferring mortgages and consolidating credit facilities. The customer can easily understand the umbrella nature of the all-purpose collateral mortgage facility and will value the reduced fees and rates.

#### **5.4.2 CRM Solution**

Another approach to differentiating is by way of a CRM solution. It is important the credit union be good at anticipating customer needs. This is not a technology – but a strategy.

CRM will touch most aspects of the credit union banking services, both retail and business. One of the challenges in implementing a CRM strategy is to break down organizational silos. Credit unions have an advantage over the banks in doing this because of the smaller size and generally limited small business customer base. Larger banks have dedicated teams of people managing separate products and services and collaboration becomes difficult. Smaller, regional organizations such as credit unions that are thinking of entering the small business market can implement a CRM strategy that leverages existing organizational frameworks. The credit union has a better chance of creating a “one-bank” model than the larger banks.

The CRM solution would essentially be an interface between the credit unions salesperson and the banking system (the computer system that store customer information files). While all of the five chartered banks currently use a form of CRM, it is rarely used for business customers. Where it is being used, work-arounds are being done because it was built to service a retail customer creating numerous limitations. The keys to any CRM implementation are data integrity and ease of use or access. If is not easy or accurate, adoption and utilization of CRM will be minimal. The advantage of the credit union is that most small financial institutions are fortunate to have core processing systems that can provide a rich starting point for customer information. The larger institutions have much more complex databases and, in addition, encounter turf battles with various departments as to IT resources.<sup>44</sup>

Utilizing a CRM solution would allow a credit union to better anticipate the needs of the small business. The technology can be written to include business rules to identify both personal and business opportunities. For example, a credit union could use CRM technology to identify self-employed retail consumers, without a related business account and no mortgage facility. The credit union could then use this information, in conjunction with a bundling strategy, to proactively contact the customer. Proactive small business solicitation of existing clients is

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<sup>44</sup> (Dver, 2003)

important for credit unions. Small business financial services are a new concept for many credit unions so the community may not know the local credit union offers small business financing.

### **5.4.3 Differentiation through Community Economic Development**

Credit unions are fundamentally different from banks by way of the focus on a cooperative philosophy, presence in rural communities and community economic development (CED). Upon entering the small business financing market, a credit union should concurrently focus on CED and leverage the goodwill it fosters in the local communities for business development.

Community economic development is the practice of promoting business development that is rooted within a local community and relates to community survival, leadership and capacity-building.<sup>45</sup> Being active and receptive in pursuing small business lending opportunities in local communities is a strong fit with the cooperative philosophy of the credit union. Developing community businesses is the original purpose of the credit unions. The founders of credit unions specified that the purpose of a credit union is to make loans for “productive purposes” – to help craftsmen buy tools, and enable farmers to improve their farms. A focus on small business in local communities builds goodwill with people within the community. Credit unions are not conventional financial institutions. Credit unions have greater capacity to influence their community environment than do most businesses – and credit unions have greater incentive to do so. For example, in a small rural community there may be one local credit union and two chartered banks. If the community fails, the banks can close branches without impact to the organization as a whole. But if the community fails, the local credit union fails as well. This does not mean the typical credit union should begin making inappropriate small business loans. It means credit unions have a unique position within the community when it comes to supporting economic growth. By focusing on the self-employed segment, the exposure is small and well

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<sup>45</sup> (Fairbairn, 1997, p. 1)

diversified. Instead of aggressively pursuing the financial services business of the town's largest employer, the credit union pursues smaller loans to several different small business owners – diversifying risk.

The ultimate CED activity is business creation: to develop new local businesses that are rooted in the community from the beginning. Businesses that grow from local roots are less likely to leave and more likely to return benefits to the community and build affinity in the business relationship with the credit union. New ventures often require not only financing, but financing advice. A local credit union is well positioned to lead and co-ordinate local and regional business development projects.<sup>46</sup> Business attraction is another way to differentiate via CED. A community becomes more diversified if it can attract businesses from other locations. This works where there is local leadership and planning, and credit unions are well situated to help because of their standing in the community, expertise and financial resources.

If CED strategies are successful, a more diversified local economy means more credit union members and customers. Examples of strong CED strategies are prevalent across Canada; however Saskatchewan credit unions have made great strides in this area. The Bengough Credit Union was involved in an economic development committee that raised shares for a hardware store. The credit union provided assistance to promote an economic development cooperative and distribute applications. Loans of up to \$1000 were offered at prime for investors in the development co-op. Nalcam Credit Union helped to reopen a community bakery by reselling a building it had acquired as loan security and partnering with other local organizations.<sup>47</sup>

A credit union has a vested interest in its local community. A CED strategy run simultaneously with a small business entry strategy differentiates the credit union from chartered bank competitors and creates goodwill and affinity with community members.

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<sup>46</sup> (Fairbairn, 1997, p. 7)

<sup>47</sup> (Fairbairn, 1997, p. 8)

## **5.5 Strategic Analysis Summary**

The first purpose of this chapter was to identify in which segments of the small business market a typical Canadian credit union should compete. The overall market was segmented into three broad strategies based on size and financial services requirements, and it was determined that the self-employed small business segment was the best fit with a credit union. The attractive characteristics of the self-employed market are: the high mix of personal and commercial financial services which increases share of wallet and profitability of the relationship; the relatively simple commercial credit requirements which limit the level of commercial expertise a credit union would have to develop; the fact this segment is a good source of low-cost deposits which is a high margin product for the credit union, and the geographic concentration of this client which is a good fit with the geographic concentration of a credit union.

The second purpose was to identify the approach a credit union should take to compete in this market and how to execute that approach. The strategic fit chapter identified a differentiation strategy as the best choice for a credit union. This approach is a strong fit to competing in the self-employed small business market, and some strategic alternatives are to bundle retail and business products to create complete solutions, to develop a self-employed focused CRM strategy and, concurrently to align any entry into the self-employed market with a CED focus.

The concluding chapter will summarize and evaluate the alternatives and recommend an implementation strategy.

## **6 RECOMMENDATIONS AND CONCLUSIONS**

The typical Canadian credit union will be most successful in the self-employed small business financing market if it adopts an organizational structure for small business that is neither product nor process driven – but market driven. This approach requires a consistent focus on the customer. This requires segmenting the small business market so that the various groups within the whole market can be serviced best according to their needs, in a manner that is profitable to the credit union serving them. A recommended segmentation was presented in the previous chapter, and the self-employed segment of the small business market was identified as the best fit for a credit union with a differentiation strategy.

### **6.1 Recommended Entry Strategy**

The typical Canadian credit union should enter the small business financing market with a differentiation strategy focused on the self-employed customer segment. Three alternatives were recommended for differentiating: bundling, a CRM strategy and implementing a CED initiative. In the short term, the credit union should focus on creating a bundled solution, and in the long term it should implement a CRM strategy and initiate CED.

#### **6.1.1 Short Term Entry Strategy**

In order to enter the self-employed small business market segment with a differentiated and competitive product and service offering, the credit union must first focus on creating a bundled offering. Of the three strategic alternatives examined, the creation of a bundled retail and business offering is the most attractive in the short term. The credit union can accomplish this very quickly and at a relatively low cost by doing market research in the local community



with small businesses. Asking its existing members – retail self-employed members and existing small business members – what services and solutions would be most desired will give the credit union a starting point. The market research would reveal unique sub-segments of the self-employed group and assist in building a business case for sustainable long term small business strategy.

Bundling could take various formats and will be specific to the needs of the local community where the credit union operates. An example was provided in the previous chapter of how a credit union could leverage provincial regulations and intimate knowledge of community development to offer a unique and differentiated product offering. Another example of bundling is to partner with local businesses to create a loyalty program. Table 4 illustrates this example.

**Table 4: Self-Employed Bundling Concepts**

<b>Focus</b>	<b>Value Proposition</b>	<b>Specifics</b>	<b>3<sup>rd</sup> Party Vendor</b>
Help Self-Employed Small Business	Improved Product Offering and Affinity	Credit Cards Client Entertainment Internet Service Building Supplies Web Page Development Fuel Travel	Desjardins Local Restaurant Local ISP Provider Home Hardware Local Web Page Developer Gas Station West Jet

The concept of this type of product bundling is to liase or partner with local businesses to offer discounts, loyalty points programs or shared advertising opportunities in exchange for co-branding a small business solution. The “Specifics” column in Table 4 identifies areas of business that would likely be important to a small business owner. In this example, having a

credit card is important for business purchases. Most small businesses have a website and require access to the Internet and likely retain the services of an Internet services provider or a Web page developer. Building supplies or fuel represent areas of major expenditures for many small businesses. “Buildings supplies” refers to the equipment or tools a tradesperson may require.

The column titled “3<sup>rd</sup> Party Vendors” lists suggested businesses a credit union could partner with. Desjardins and WestJet are national corporations and credit unions would require the support of the Credit Union Central of Canada to negotiate any arrangements. An arrangement could be made with WestJet in the small communities such as Prince George, BC by way of a points program. By opening an account at the local credit union, the small business member accumulates points every time he or she flies with WestJet and shows his or her Credit Union membership card. The local hardware store could negotiate priority pricing on large orders made by the small business owner. This is still consistent with the differentiation strategy because the Credit Union is not focusing on the price offering. Rather it is differentiating by bring a account and credit card solution to the small business segment at a price that is not the lowest in the market, but may offer price discounts at third party vendors. This list is not exhaustive and should include some retail partners as well. For example, this type of program could be tied into the collateral mortgage refinance example described in the previous chapter. The chartered banks are committed to national alliances and affiliations and would not be able to create customized affinity programs to the extent the credit union could.

### **6.1.2 Long term Entry Strategy**

Over the long term the credit union should consider a CED and CRM strategy to support a small business initiative. Although the bundling solution provides a unique market offering, it is important for the credit union to retain the new small business relationships it acquires. To do so, the credit union must invest in a customer relationship management (CRM) technology. This would be best accomplished by utilizing resources at the provincial central credit union to help

lower the cost of such an investment. The investment is not required in the short term because most credit unions do not have the small business market penetration to justify or fully utilize all the advantages that a CRM strategy could provide.

A CED plan should accompany a small business strategy once the credit union has identified the specific sub-segments of its local small business community it wants to pursue, and solidifies its product and service offering. Credit unions have an advantage when focusing on the broader kind of community development. The broader approach gives a community not just job creation, but also skills, capacity and leadership to sustain the economic development. Credit unions have a greater capacity to influence their community environment than do the banks, because credit unions have local control in defining needs, identifying solutions and evaluating results. The board of directors typically consists of community and business leaders, and their memberships represent community networks. In the economic sphere, credit unions administer pools of capital under democratic control that can be distributed according to local priorities; and the economic surpluses that are accumulated are reinvested back into the communities.<sup>48</sup> A chartered bank must spread its funds allocated to community development across hundreds of communities, whereas the credit union is isolated to one community. A strong CED strategy can create a competitive advantage by building strong goodwill and support within the local community in which the credit union operates.

## **6.2 Implementation**

There are five key steps a credit union should follow when implementing a self-employed small business strategy. In order these steps are: 1) perform an internal evaluation; 2) conduct local market analysis; 3) define the self-employed small business market; 4) determine product development priorities and; 5) ensure infrastructure and cross-functional business unit support.

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<sup>48</sup> (Fairbairn, 1997, p. 15)

### **6.2.1 Perform an Internal Evaluation**

The credit union must first perform an internal evaluation to determine its specific strengths and weaknesses in terms of human resources, technology and product line up. It must decide if there is sufficient expertise within the credit union to conduct small business “conversations” or whether additional recruitment is necessary. As a credit facility is the most common step towards forming a new small business relationship, the credit union must assess its current retail underwriting process. One of the reasons the self-employed small business segment was identified as a target market was because of the heavy reliance on the personal covenant to support the credit request. Credit unions have a competence in servicing the retail customer and can transfer that competence to a product or service for the small business owner. The credit union must examine the existing customer base to determine if further segmentation is warranted based on specific industry within the geographic region the credit union services.

### **6.2.2 Local Market Analysis**

The logical step that follows is conducting local market analysis. The credit union should determine the size of the market it intends to service and the best marketing medium to reach this group. At this time, it should conduct a competitor analysis. Credit unions are often found in rural communities where only one or two major banks have a presence. Because of how centralized the banks have become, there is an opportunity for the local credit union to customize an offering for the needs of the local community. Market gaps and niches should be identified at this stage. An example of a niche market could be a sub-segment of the self-employed small business market. In Fort McMurray, Alberta there are several large oil and gas processing refineries. The majority of people working at these refineries are independent contractors performing special heavy equipment operations. As a result there may be an opportunity to focus on the Communication, Energy and Paper Workers (CEP) Union as a niche market as most of these independent contractors would be members.

### **6.2.3 Define the Self-Employed Small Business Market**

Following market analysis is the task of specifically defining the small business segment by attributes and characteristics. The credit union should match internal capabilities to these customer segments for the best organizational fit. The self-employed small business segment should be analyzed by profit potential, products used, average account balances and the retail cross sell potential. For example, a credit union located in a shopping mall could create a bundled product offer to small business mall retailers that included a merchant services solution. It is better for the credit union to start with a narrow focus, with expansion on the horizon. By striving to be all things to all customers, the value proposition becomes diluted and it is more difficult to differentiate.

### **6.2.4 Product Development Priorities**

When the target market is narrowly defined, product development priorities should be identified. The needs of the self-employed small business segment are simple, and therefore only a few core commercial products are required initially. The development will be in how these products are bundled with retail products. There is opportunity at this stage to develop affinity programs with third party vendors. This adds sophistication and credibility to the credit union brand as it relates to commercial financial services – something small businesses may not have historically associated with the credit union. For example, the small business owner likely owns a vehicle so a credit union could have the organization that provides its retail visa card create a business visa card with an Esso loyalty program.

The product development and bundling is a critical stage of entering the small business financing market. The credit union should avoid re-branding retail products to become small business products. The analysis of the segment will reveal characteristics important to the sub-segments and will determine each credit unions product and services mix. Value must be evident for the small business owner or, with the small business owner's tendency to mix personal and

business finances, the owner will revert to using personal products to meet business needs. The objective is to build from the retail product base but differentiate to the degree there is added value to the small business owner which consequently justifies the associated fees or rates. For example, a small business owner would value the ability to log on once to an online banking platform and transfer money between a personal and business account. In addition, at year end, the owner could then sort transactions so transfer records could easily be identified and emailed to the small business owner's local accountant. Simplified accounting would save the small business owner money they would have to pay the accountant to sort through records and therefore it is likely the small business owner would pay a premium for this service.

#### **6.2.5 Infrastructure and Business Unit Support**

A small business strategy will require the support of various business units that currently support the retail financial services. Operations, transaction platforms and systems development must keep the small business owner in mind when making enhancements or upgrades to existing infrastructure. There will be instances unique to the small business that cannot be easily transferred to a retail environment (For example: due diligence on a new business relationship includes searching the corporation name via a provincial database to ensure the directors are who the owner indicates and no other institution has prior interest in this corporation. There is no equivalent on the retail side for this type of due diligence requirement) Compensation, as a business unit within the human resource function, must incent employees to undertake the challenge of servicing the small business owner. In general, there has to be an overall integration into the retail infrastructure.

## **6.3 Additional Strategic Considerations**

### **6.3.1 Economies of Scale and Scope**

Credit unions have the opportunity to achieve scale by outsourcing certain activities to other entities that can operate at a scale that is not achievable by the credit union. For example, Coast Capital Savings, Canada's second largest credit union, recently switched from being a MasterCard provider to a Visa provider. In doing so, it retained the services of Canadian cooperative Desjardins. Desjardins is Canada's largest financial cooperative group, with assets surpassing \$100 billion and the company holds competencies in credit card services. The expectation is that Coast Capital Savings will receive a higher rate of return on its investment in the larger corporation than if had attempted to offer the services in-house. A small business strategy may require negotiation of similar alliances with such organizations as payroll service providers to provide the full solutions the clients will demand.

### **6.3.2 Board of Directors Commitment**

Strong board and management commitment is required for a successful small business financing strategy. The board must be comfortable culturally with the concept of business lending and relationship expansion. Traditionally, credit unions have not been involved in small business financial services. The ability to present a strong risk management system will be a key driver in the ability to begin the design of credit solution.

## **6.4 Conclusion**

This research project presented a strategic analysis of a typical Canadian credit union's participation in the small business financing market. Factors currently impacting this industry are examined through Porter's Five Forces and it is concluded the small business financial market represents an attractive opportunity for a credit union to enter with a differentiated strategy. By

segmenting the overall small business market in Canada into three groups, the “self-employed small business” segment was the recommended target segment.

On the basis of the research presented, the credit union should pursue entry into the self-employed small business financial services market. By first creating a series of retail and commercial bundled solutions, and then implementing a CRM and CED strategy, the credit union can compete over the long term with a profitable offering. The credit union will have to gain the support of its Board of Directors and look to create partnerships in markets that demand and expanded product offering in order to implement this strategy successfully. As legislation changes to increase competition in the financial services sector and credit unions continue the recent trends of amalgamation, weaknesses in the areas of scale and size will be overcome. The key to the success in this market will be focusing on differentiating from the chartered banks offerings and providing complete relationship – not product – solutions for the small business owner.



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# APPENDICES

## Appendix A – Value Chain

Firm Level Value Chain for Small Business at a Typical Credit Union

<b>Infrastructure</b>	Distribution Lending	Deposits Cash Management	Finance
<b>Risk &amp; Financial Management</b>	Financial Control Asset & Liability Management	Financial Reporting Treasury	Audit Compliance
<b>Technology</b>	Computing Services Service Management	Solutions Delivery Enterprise Architecture	
<b>Human Resources</b>	Staffing Resourcing	Compensation Organizational Design	Measurement Employee Services Training
<b>Primary Activities</b>	<b>Processing</b>		
<b>Components</b>	<b>Insight</b> <b>Product Planning</b> - bundling - parameterization - solutions Data Mining System Development Fundraising	<b>Document Management</b> Customer Accounts Cash Management <b>Credit Decisioning</b> Training Scale Efficiencies	<b>Distribution</b> Sales Force <b>Small Business Expertise</b> Advice <b>Cross-selling</b> <b>Branch Network</b> CRM <b>Customer Services</b> <b>Advisory Services</b> Electronic Network
<b>Outsourced</b>	Segmentation Analysis	Credit Card Transactions Merchant Services	Credit Scoring
	INBOUND	OPERATIONS	OUTBOUND
		MARKETING	SERVICES

\* Core competency in **BOLD**

## Appendix B – Top 100 Credit Unions in Canada<sup>49</sup>

Current Rank	Credit Union	Province	2Q 2002	Members	Locations
1	Vancouver City Savings	BC	\$6,630,196,744	280,380	39
2	Coast Capital Savings	BC	5,982,725,371	299,132	44
3	Envision	BC	1,751,557,169	106,072	20
4	Capital City Savings	AB	1,576,532,889	127,601	25
5	Community Credit Union	AB	1,322,371,142	99,615	24
6	Niagara Credit Union	ON	1,301,833,993	86,280	16
7	Civil Service Co-op	ON	1,167,162,074	149,163	20
8	Steinback	MB	1,152,502,615	46,314	1
9	Hepcoe Credit Union	ON	1,114,266,109	78,465	26
10	First Calgary Savings	AB	1,088,505,913	94,536	12
11	Prospera	BC	1,053,635,835	44,956	14
12	Westminster Savings	BC	1,000,347,957	64,566	11
13	Thompson Interior	BC	990,164,263	77,630	20
14	North Shore Credit Union	BC	866,257,520	35,305	11
15	Sherwood Credit Union	SK	826,864,585	60,888	15
16	First Ontario Credit Union	ON	729,474,000	61,758	19
17	Cambrian	MB	668,972,401	41,383	12
18	Valley First	BC	666,552,007	40,251	13
19	St. Willibrord Community	ON	625,120,751	37,537	11
20	Assiniboine	MB	558,716,372	50,020	11
21	Island Savings	BC	551,153,518	33,262	10
22	Border Credit Union	AB	540,111,334	20,511	3
23	Saskatoon Credit Union	SK	539,914,825	48,919	8
24	Kootenay Savings	BC	520,624,039	39,547	13
25	Coastal Community Credit Union	BC	480,108,619	38,547	9
26	Metro Credit Union	ON	463,884,580	45,629	11
27	DUCA Community	ON	433,149,122	29,418	13
28	Westoba	MB	404,163,886	34,003	15
29	Northern	ON	403,371,695	41,085	19
30	Lloydminster Credit Union	SK	384,058,661	22,056	11
31	Mennonite Credit Union	ON	365,838,620	13,665	8
32	Southwest Credit Union	SK	363,449,087	25,321	13
33	Prince Albert Credit Union	SK	348,244,860	36,831	11

<sup>49</sup> (Credit Union Central of Canada, 2004)

<b>Current Rank</b>	<b>Credit Union</b>	<b>Province</b>	<b>2Q 2002</b>	<b>Members</b>	<b>Locations</b>
34	Battleriver Credit Union	AB	325,087,370	15,657	11
35	Windsor Family Credit Union	ON	305,432,617	19,200	5
36	Gulf and Fraser Fishermen's	BC	301,249,200	15,237	5
37	Battlefords Credit Union	SK	296,319,300	19,478	10
38	St. Stanislaus	ON	294,874,173	36,072	15
39	Evergreen Savings	BC	291,720,851	19,637	10
40	Estevan Credit Union	SK	290,562,238	22,585	12
41	Astra	MB	283,405,527	19,393	8
42	C.P. de Shippagan	NB	277,734,000	30,035	3
43	Van-Tel/Safeway Employees	BC	263,519,387	18,739	5
44	Heartland	MB	262,882,852	14,277	3
45	Kawartha Credit Union	ON	255,890,555	30,383	9
46	United Civic Savings	BC	254,218,276	12,830	8
47	Budichnist Credit Union	ON	254,024,951	14,208	6
48	Ukrainian Credit Union	ON	252,414,926	19,344	11
49	Salmon Arm Savings	BC	238,260,821	18,899	3
50	Northern Savings	BC	237,576,535	16,281	4
51	C.P. Trillium	ON	235,847,171	17,380	9
52	South Interlake	MB	231,598,922	15,356	10
53	Hy-Line	MB	230,425,447	14,465	5
54	Teachers' Credit Union	SK	229,002,001	12,270	2
55	Hamilton Teachers' Credit	ON	219,825,345	12,755	5
56	Aldergrove	BC	217,734,830	18,962	4
57	Newfoundland and Labrador	NF	209,517,818	12,225	12
58	1ST Choice (5)	AB	208,855,024	15,736	7
59	Woodslee Credit Union (6)	ON	207,338,473	20,952	8
60	Crosstown	MB	197,449,999	11,644	3
61	Wainwright Credit Union	AB	196,750,198	8,675	6
62	Advantage Credit Union	SK	193,410,853	9,368	9
63	Community Savings	BC	191,403,628	12,003	5
64	Yorkton Credit Union	SK	191,276,233	12,374	7
65	Mountain View Credit Union	AB	191,184,025	14,850	7
66	Weyburn Credit Union	SK	190,177,699	9,384	2

<b>Current Rank</b>	<b>Credit Union</b>	<b>Province</b>	<b>2Q 2002</b>	<b>Members</b>	<b>Locations</b>
67	ASCU Community	ON	188,573,397	11,813	3
68	Auto Workers Community	ON	188,460,804	17,080	2
69	Prairie Centre Credit Union	SK	186,972,097	11,646	10
70	Sunshine Coast Credit Union	BC	174,230,533	12,738	3
71	C.P. Saint-Boniface	MB	172,958,821	9,677	5
72	Servus Credit Union	AB	171,121,360	12,425	6
73	Brooks Credit Union	AB	171,107,753	9,789	3
74	C.P. de Hearst	ON	170,419,905	11,356	3
75	Yellowhead Credit Union	AB	165,064,959	14,206	7
76	Credit Union Atlantic Ltd.	NS	164,807,277	15,945	6
77	Bulkley Valley	BC	163,280,034	13,350	4
78	Vanguard	MB	163,011,438	9,648	15
79	Lakeland Credit Union	AB	162,997,293	9,516	2
80	Agassiz Credit Union	MB	158,938,013	10,546	5
81	Grand Forks District Savings	BC	154,024,169	10,688	1
82	Altona	MB	152,986,656	5,681	2
83	Comox Valley	BC	151,095,231	14,350	3
84	C.P. Kapuskasing	ON	150,791,017	16,344	6
85	Carpathia	MB	147,650,778	10,759	4
86	Waterloo Regional	ON	147,527,967	13,632	3
87	Greater Toronto Area (GTA)	ON	147,271,351	12,424	8
88	Bayview Credit Union	NB	144,920,000	20,404	6
89	Prince George Savings	BC	143,585,415	12,394	3
90	Assiniboia Credit Union	SK	140,236,253	6,876	6
91	Polysar Lambton	ON	140,078,519	9,962	4
92	Clinton Community	ON	140,044,990	12,118	2
93	Page Credit Union	SK	138,847,692	10,164	4
94	Virden Credit Union	MB	138,328,813	8,420	5
95	Lake View	BC	133,314,790	13,234	3
96	Canora Credit Union	SK	131,768,875	8,786	9
97	Parama Lithuanian	ON	129,231,397	6,289	3
98	Civic Credit Union	MB	128,275,183	7,110	2
99	Police	ON	127,851,399	10,566	5
100	Shell	AB	125,851,431	6,670	1

**\$50,114,429,411 3,257,906**