

**BASEL II: THE NEW CAPITAL ACCORD
A STRATEGIC ANALYSIS OF THE IMPACT ON A
SCHEDULE 2 BANK**

by

Kevin Gerard Mathias, B.Com., AICB

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APPROVAL

Name: Kevin Gerard Mathias

Degree: Masters of Business Administration

Title of Project: Basel II: The New Capital Accord
A Strategic Analysis of the Impact on a Schedule 2 Bank

Examining Committee:

Dr Steve Globerman
Senior Supervisor
Adjunct Professor

Jill Shepard
Second Reader
Assistant Professor

Date Approved: August 10, 2004

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ABSTRACT

The global banking industry is competitive and the Canadian industry no less so. Banks are therefore always looking for ways to increase their competitiveness and for new opportunities to expand their business. HSBC Bank Canada (HBCA), a full service bank with 120 branches across Canada, is no exception to this general statement.

A potential growth opportunity is presented by the SME sector which is a significant part of the Canadian economy, contributing 45% to GDP. Large corporate loan losses in recent years as well have caused banks to focus their efforts on the small and medium enterprises sector.

The global banking system is undergoing significant change, resulting from new rules introduced by Basel II. The new rules change the methodology used by banks to calculate regulatory capital. Banks that adopt advanced approaches to calculating regulatory capital will be required to maintain less capital. Initial studies of Basel II, indicate a 30% reduction in capital for lending to SMEs. This reduction in capital will allow banks to offer more competitive pricing or increase the amount of the loan they are now prepared to offer an SME.

The expected continued growth of the SME sector, along with capital benefits available under Basel II for lending to SMEs, are reasons for HBCA to pursue SME business. Furthermore, HBCA is particularly well positioned to take advantage of the

opportunities available from the SME sector as it is ranked highest among the banks in various surveys, for banking services to the SME sector.

Certain challenges still exist, both culturally and technologically, related to HBCA's ability to handle the large volumes of customers within the SME market. However, HBCA has demonstrated an ability to adapt to change. Over the years, as it has acquired different entities, HBCA has successfully integrated different cultures with its own, while retaining its own reputation within the SME sector. Its success in the SME sector is likely if it manages techno-cultural challenges in line with market needs.

DEDICATION

This paper is dedicated to my wife Louella and sons Ryan and Andrew for their love, patience and understanding, especially during the past two years.

It is also dedicated to my parents, Tino and Yvonne Mathias, for their unconditional love and support.

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1 INTRODUCTION

The Canadian financial services sector is mature, sophisticated and extremely competitive. It has been able to survive challenges presented by a significant degree of global financial stress, technological innovation, increasing globalization of financial services, emergence of new competitors and more informed consumers. Canadian banks must stay competitive in the face of increasing competition domestically from credit unions and finance companies and internationally from foreign financial institutions.

“Large corporate loan losses and a prolonged slump in investment markets have forced banks to rethink their strategies and focus their efforts on the household credit and small and medium enterprises (SME)¹ sectors². “While the relative weakness in business credit primarily reflects reduced demand owing to economic conditions, losses on business loans have encouraged banks to place increased emphasis on the household sector, including retail lending and wealth management activities. The growth in credit to small businesses has been much better sustained than that to large firms.”³ Growth in both the household credit sector and the SME sector has been very strong in recent years, and while both sectors offer a positive supportive environment for banks to grow business in

¹ Statistics Canada, Fall 2002. In its Survey on Financing of Small and Medium Enterprises Statistics Canada qualified SMEs as enterprises with less than 500 employees and less than \$50 million in gross revenue. It did not include non-profit enterprises, Cooperatives, Joint ventures, Municipal/Federal Government and Enterprises in specific industries, identified by the North American Industry Classification System.

² Shareowner, Jan/Feb 2003 pg 12

³ Financial System Review, Bank of Canada, December 2003 pg 4

the future, the requirements of the New Capital Accord⁴ (proposed by The Basel Committee on Bank Supervision) has triggered fundamental changes in the attitude of banks towards borrowers, especially SMEs.

HSBC Bank Canada has, over the years, developed a strong customer service culture and has constantly been rated the highest for overall quality of customer service amongst all banks in Canada (especially in the small and medium size enterprise market⁵). The Bank considers its strong customer service culture a competitive advantage, and it is pursuing a growth strategy to expand and build on its strengths as a provider of financial services to small and midsize companies.

The purpose of this paper is to provide a strategic analysis of HSBC Bank Canada, its position in the Canadian financial services industry, and the impact that Basel II will have on its strategy. The scope of the paper will be restricted to the lending activities of the Bank due to the primary focus of Basel II on credit risk. The Bank's lending activities will be discussed relative to the SME sector, since initial studies indicate a reduction in capital requirements for SME exposures managed in line with the more advanced methods provided by Basel II for calculating capital.

⁴ The New Capital Accord commonly known as Basel II is a revision of the 1988 Basel Capital Accord, a global standard by which the financial soundness of banks is assessed.

⁵ CFIB Banking Survey, October 2003.

1.1 HSBC Bank Canada

HSBC Bank Canada (“HBCA”), a subsidiary of HSBC Holdings plc, (“HSBC Group”) is the largest international bank in Canada with 160 offices including 120 bank branches across Canada. HBCA employs in excess of 6,000 employees and administers \$38 billion in assets.

The HSBC Group is one of the largest banking and financial services organizations in the world. The HSBC Group started as a British Bank in 1865 financing trade in the Asia Pacific region. It has since grown to over 9,500 offices in 79 countries and had assets of US\$1,034 billion as of December 31, 2003. Utilizing a global network linked by advanced technology, including a rapidly growing e-commerce capability, the HSBC Group provides a comprehensive range of financial services.

HBCA entered the Canadian banking industry in 1981 following changes to the Bank Act that allowed foreign banks to operate in Canada. Since 1981, HBCA has grown into Canada’s seventh-largest bank. Much of the growth in number of branches has been achieved by the acquisition of other banks, the two most notable being the Bank of British Columbia in Western Canada in 1986 and Lloyd’s Bank of Canada in Eastern Canada in 1990. Since 1991, HBCA expanded its activities in the financial services industry by acquiring a property and casualty insurance company (HSBC Canadian Direct Insurance Incorporated), a trust company (HSBC Trust Company (Canada)) and an investment management company (HSBC Asset Management (Canada) Limited). It has expanded its financial market facilities by establishing a discount brokerage service (HSBC InvestDirect) and a full service brokerage and underwriting capacity (HSBC Securities (Canada) Inc.). Now twenty-three years after opening its doors, HSBC Bank

Canada is a full-service, nationwide financial services organization with the lowest loan loss rate and highest rate of return on equity in Canada. Its reputation for innovation, integrity and quality service is undisputed, and its unmatched links to some 82 countries and territories with more than 5,000 offices throughout the world makes it a growing force in the Canadian financial services market".⁶

HBCA maintains a presence in each of Canada's provinces except Prince Edward Island. In support of its branch network, HSBC offers access to its products via alternate distribution channels, telephone banking and Internet Banking. With almost half of its Canadian offices in British Columbia, the bank is targeting growth in Toronto, Montreal and Calgary.⁷

HBCA is a fully integrated financial services organization providing personal and commercial banking services, corporate, investment banking and market services, online and full service brokerage, investment management and personal trust services through the following entities:

HSBC Bank Canada

HBCA offers a full range of Commercial Financial Services that include; deposit services, treasury, cash management, electronic banking, asset management, term and operating credits, import and export finance, equipment leasing and investment capital financing. It also offers a full range of Personal Financial Services that include; deposit services, personal lending including mortgages, private banking, mutual funds, Internet

⁶ The British Canadian Chamber of Trade and Commerce, //www.bcctc.ca/conn20-3/banking

⁷ Bloomberg.com, May 13, 2004

and telephone banking, full service investing and self-directed investing, trust services, and property and casualty insurance services.

HBCA manages its operations by the following customer business groups i) Personal Financial Services provides services to individuals through a segmented approach to understanding and meeting customer needs ii) Commercial Banking provides services to small and medium sized enterprise business, one of the HSBC Group's traditional strengths, both in Canada and worldwide and iii) Corporate, Investment Banking and Markets provides a comprehensive range of corporate financial services to an international group of large multinational clients who have a need for international value added products through investment banking, structured lending and trade services. To these clients, it offers corporate banking, asset management, investment banking, merger and acquisition advisory, treasury and trade finance services.

HSBC Asset Management (Canada) Limited

HSBC Asset Management (Canada) Limited provides investment management services to institutional, retail and high net worth private clients. Its institutional and corporate business originates primarily from financial institutions, foundations, public services, trade unions and universities. In recent years, it has expanded and created an institutional market niche by providing investment management services to unique organizations such as foundations and other non-profit organizations.

HSBC Securities Canada Inc.

HSBC Securities provides investment services and products to corporate and retail investors. As a full-service broker, HSBC Securities Investment Advisors work one-on-one with clients to create strategies for building wealth. They assist clients through all phases of this process, from defining investing goals, to conducting research on investment products and opportunities. HSBC InvestDirect offers online investment services for self-directed investors.

HSBC Trust Company (Canada)

HSBC Trust Company (Canada) is able to provide personalized, professional service enhanced by the global network of one of the world's leading international banking and financial services organizations.

HSBC Investment Funds (Canada) Inc.

HSBC Investment Funds (Canada) Inc. is the principal distributor of HSBC Mutual Funds, which offers a wide variety of professionally managed no-load mutual funds tailored to meet the changing investment objectives of the individual investor.

1.2 The New Capital Accord - Basel II

Every bank is required to maintain capital that must be sufficient to protect the financial services organization's depositors and counterparties from the risks of the bank's on and off-balance sheet risks⁸. The level of capital that a bank maintains is measured by its capital adequacy ratio⁹. Minimum capital adequacy ratios are required to ensure that banks can absorb reasonable levels of losses before becoming insolvent, and before depositors funds are lost.

The Basel Committee of the Bank for International Settlements ("BIS Committee"), established in 1974, is a representative for central banks and financial supervisory authorities of the major industrialized countries (the G10 countries).

1.2.1 The 1988 Basel Capital Accord

In 1988 capital ratios of banks in many countries were generally perceived, by regulators, as too low. The "Basel Capital Accord" was established to recommend minimum capital adequacy ratios for international banks, and to standardize international regulatory practices of banks. The current capital requirements from the 1988 Capital Accord are simple - a one size fits all approach, focusing on credit risk. The calculation method is also simple: claims that a bank has on others are sorted according to their relative risk, and then one of four risk weights is applied to each in order to derive average risk weighted assets. Banks are required to maintain a minimum of 8% capital of the resultant average risk weighted assets. While it corrected the irregularities facing the

⁸ International Financial Risk Institute June 2000)

⁹ The capital adequacy ratio is the ratio of the amount of a bank's capital expressed as a percentage of its risk weighted credit exposures.

banking industry in 1988, the 1988 Accord was, found to be lacking given the complexities in financing the requirement of modern day businesses. One of the anomalies in the 1988 accord allowed an OECD bank loan capital relief simply because it was made to a bank, while a higher-rated corporate entity attracted a 100% risk weight (e.g. a loan to a AAA rated non-financial institution attracts a 100 per cent risk weight whereas a loan to any OECD bank, rated AA and therefore more risky than AAA, attracts only 20%). This indicates that a bank would have to provide five times more capital against the loan to the AAA rated non-financial institution than that to the AA rated OECD bank.

The 1988 Basel Accord focused on credit risk; i.e. the risk of loss due to borrower or counterparty default. However in the years subsequent to its implementation, several factors, including increased market volatility, the Asian and Russian monetary crises, the collapse of Barings, problems with Sumitomo Capital, and bankruptcies/collapses of major corporations such as WorldCom and Enron¹⁰, have caused regulatory authorities to reconsider the Basel Accord. In his impact analysis of the 1988 Accord, Patrick Van Roy found that “empirical research failed to answer the question, whether the 1988 agreement was effective in raising capital ratios among banking institutions above minimum capital requirements¹¹.” The 1988 Basel Accord also focussed primarily on corporate and sovereign risk and did not include retail and SME exposures. Regulators have since determined that retail and SME exposures should be eligible for capital relief due to the smaller amounts of money involved and the large volume of loans. Retail and

¹⁰ Gabe and Sidler Jul 2003, p. 5

¹¹ Van Roy, Patrick, Dec 2003, p. 2

SME exposures are being included for the first time in the assessment of credit and operational risk for capital calculations in Basel II.

1.2.2 Basel II – The New Capital Accord

Basel II is a framework for the regulation of capital adequacy in banks as proposed by the BIS Committee. Its intention is to replace the 1988 Accord with a structure which relates regulatory capital for credit risk more closely to the underlying risks involved, and for the first time introduces regulatory capital for operational risk. Basel II does not change the definition of capital contained in the 1988 Accord, and banks will continue to maintain the minimum requirement of capital at 8% of risk weighted assets. Figure 1 compares the existing proposal under the 1998 Accord with the proposed proposals outlined in Basel II.

Figure 1: Rationale for a new Accord: More flexibility and risk sensitivity

Existing Capital Accord	Proposed New Capital Accord
Focus on a single risk measure	More emphasis on banks' own internal methodologies, supervisory review, and market discipline
One size fits all	Flexibility, menu of approaches, incentives for better risk management
Broad brush structure	More risk sensitivity

Source: *The New Basel Capital Accord: An Explanatory Note, Jan 2001, p 6*

Safety and soundness in today's dynamic and complex financial system can be attained only by the combination of effective bank-level management, market discipline, and supervision. The 1988 Accord focussed on the total amount of bank capital, which is vital in reducing the risk of bank insolvency and the potential cost of a bank's failure for depositors. Building on this, the new framework intends to improve safety and soundness in the financial system by placing more emphasis on banks' own internal control and management, the supervisory review process, and market discipline. Banks have two options to calculate credit risk. The

more sophisticated and risk sensitive the approach, the less the estimated capital requirements.¹²

The two main approaches to calculating regulatory capital are:

- Standardized approach, which is the simplest and is generally unchanged from the 1988 Capital Accord.
- The Internal Ratings Based (“IRB”) approach which relies upon a bank’s internal assessment of its counterparties and exposures. Banks have two options under the IRB Approach
 - Foundation IRB Approach where the risk variables are more standardized and set by regulators.
 - Advanced IRB Approach where the bank uses its own estimates for risk variables. The Advanced Approach is considered the most sophisticated and restrictive of the two options.

The IRB approach provides for a finer differentiation of risk than the Standardized approach and is expected to “secure two key objectives consistent with those that support the wider review of the New Basel Accord”¹³.

- Risk Sensitivity: more sensitive to the drivers of credit risk and economic loss
- Incentive compatibility: encourages banks to continue to improve their internal risk management practices

¹² Bank for International Settlements, Jan 2001

¹³ Gabe and Sidler, Jul 2003, p. 11

The implementation of Basel II will present banks with significant requirements to account and track data if they want to obtain capital relief under the new capital regime. Initially banks will have to establish credit risk and operational models involving processes and data according to standards stipulated by the regulators. Once established, these models will have to be validated through back testing and stress testing using at least five years of auditable and reconcilable data.

1.2.2.1 Coverage

The BIS Committee expects large internationally active financial institutions, like the HSBC Group, to utilise more advanced risk management systems and adopt the more sophisticated approaches to calculating regulatory capital. The Office of the Superintendent of Financial Institutions (“OSFI”) has defined qualifying banks in Canada as those that have total capital (after deductions) in excess of \$ 5 billion Canadian, or that have greater than 10% of total assets, or greater than 10% of total liabilities that are international.

Banks will be expected to categorize their businesses into six broad classes of assets, and demonstrate to their regulators that the methodology for assigning exposures to the different classes is consistent over time. In terms of credit risk, the largest impact on capital calculations for a universal bank¹⁴ like HBCA will be in the areas of retail and SME. The three main classes applicable to HBCA are:

¹⁴ A Universal bank is one that can provide all banking services, such as, credit/lending business, asset management and investment advice, payment transactions, deposit business (savings accounts, etc.) securities business (stock exchange transactions) underwriting business (issuing of bonds) financial analysis.

1.2.2.2 Corporate Exposures

This is the debt obligation of a corporation, partnership or proprietorship. The source of repayment is based primarily on the ongoing operations of the borrower rather than cash flow from a project or property.

1.2.2.3 SME Exposures

SME exposures are different from corporate exposures because of the smaller amounts of money involved and the primarily domestic focus of the underlying business.

1.2.2.4 Retail Exposures

Retail exposures are different from corporate exposures because of the large volume and small average amounts of retail loans. Retail loans must be part of a large pool of loans that are managed in a comparable fashion and are pooled to...

- Meaningfully differentiate levels of risk
- Ensure that risk characteristics of borrowers within the pool are relatively homogenous
- Ensure that risk characteristics of the underlying pool are stable over a period of time

The stated objective of the Basel Committee is to leave the overall level of regulatory capital in the banking system largely unchanged. In October 2002, the Basel Committee on Banking Supervision initiated the third Quantitative Impact Study (QIS3) involving a range of banks across 43 countries. The objective of the study was to allow the Committee to gauge the impact of the Basel II proposals on minimum capital requirements.

Table 1 indicates that there should be an overall reduction in capital across the board of around 2%. The Accord will however permit a modest reduction for firms using the more advanced approaches for calculating regulatory capital.

Table 1 Average contribution to change under the Advanced IRB approach

Portfolio	% of Current Capital	% change in capital requirement	Contribution
Corporate	30	-14	-4
Sovereign	1	28	1
Bank	5	16	0
Retail (total)	21	-50	-10
- Mortgage	11	-60	-5
- Non-Mortgage	8	-41	-3
- Revolving	2	14	0
SME (Total)	18	-13	-3
Equity	2	114	2
Trading Book	8	2	0
Securitized assets	2	129	0
Other portfolios			3
General Provisions			-3
Overall credit risk		-14	-14
Operational Risk			12
Overall change		-2	-2

Source: Quantitative Impact Study 3 – Overview of Results, Basel Committee May 5, 2003

Table 1 provides the expected changes in capital requirements on the different asset classes of a financial institution.

The main area of activity where the minimum capital requirement will change substantially is the retail portfolio, where the risk weights have been lowered significantly for all sub- portfolios (excluding past due assets) relative to the current Accord. The large contribution across all

groups reflects the combination of these changes with the importance of retail activity for many participating banks¹⁵.

Initial studies suggest a 30% reduction in the capital requirements for retail exposures managed in line with the more advanced approaches of Basel II. The retail segment is differentiated from the corporate segment for capital treatment because of the large volumes and small amounts of money involved. For the purposes of Basel II retail portfolios are defined as¹⁶:

- Exposures to individuals (regardless of exposure size)
- Residential mortgage loans
- Small Business facilities provided the total exposure to the counterpart is less than Euro 1 million

In their December 2003 report Mercer Oliver Wyman¹⁷ provided reasons why retail exposures should attract capital relief. They said “the most likely cause of default for corporate and banking exposures is macro-economic weakness, or systemic risk, but this is less significant for retail borrowers than life¹⁸ events such as unemployment, divorce, illness and so on. Consequently retail portfolios contain more diversifiable idiosyncratic risk and should attract less capital per unit of credit risk”. The same report indicated that the new rules are expected to release an aggregate amount of capital in the US roughly equivalent to the entry of a major ‘new’ retail institution perhaps the size of Wells Fargo. Oliver Wyman expects universal banks to use some of the regulatory capital released by retail lending to support their wholesale banking activities.

¹⁵ Quantitative Impact Study 3 – May 2003

¹⁶ CP3, para 199

¹⁷ Mercer Oliver Wyman, Dec 2003, p 26

¹⁸ Non-business related

2 INDUSTRY ANALYSIS

“Canada’s financial sector experienced significant changes over the past decade as it responded to such factors as technological innovation, globalization, and a low and stable rate of inflation. Shifting demographics also exerted important effects, as Canada’s aging population increased its focus on retirement savings and asset accumulation. This change in savings behaviour contributed to a convergence of functions among financial institutions as they sought ways to position themselves to maximize their share of the asset- and wealth-management business”¹⁹ An industry analysis of the Financial Services Industry is conducted within Michael Porter’s five factor industry analysis framework.

2.1 SME Sector

An understanding of the SME sector is important before proceeding with an analysis of the Canadian Financial Services Industry. This section will provide a definition of an SME, and will briefly discuss the growth opportunities in the SME sector in Canada. Statistics Canada defines small and medium enterprises as those with less than 500 employees or less than \$50 million in gross revenue. It does not include non-profits (schools, hospitals, charities,), Cooperatives, Joint ventures, Municipal/Federal Government and Enterprises in specific industries, identified by the North American Industry Classification System. The definition of SME varies from financial institution to financial institution, and from country to country, based on the risk appetite for this

¹⁹ Daniel, Winter 2002-2003, p. 4

business, and the level of sophistication of technology available to manage this business.

The following are some of the definitions in use.

Source	Definition
BIS – Basel II	Credit facilities to a small business will be eligible for capital relief provided the total exposure is less than Euro 1 million.
HSBC Group	Businesses with sales of less than \$ 20 million US Dollars may be treated as SMEs
Canadian Bankers Association	Authorized business credit under \$ 1 million Canadian Dollars.
Royal Bank, CFIB*, CME** Oct 2002 study	Enterprises that employ less than 250 people

* CFIB - Canadian Federation of Independent Business,

** CME - Canadian Manufacturers & Exporters

Domestic factors that influence developments in the Canadian financial system include: the state of the Canadian economy, the financial position of the household and corporate sectors, and developments within specific sectors. In Chapter I, Shareholder magazine was quoted as reporting that banks are focusing their attention on the household credit and SME credit sectors. Growth in both of these sectors has been very strong in recent years, and both the household credit and SME sectors offer a positive supportive environment for continued growth.

Consumer confidence remains at a high level, evidenced by a strong domestic housing market and strong auto sales, leading to growth in the mortgage and consumer credit²⁰ market. Low mortgage rates, due to the low interest rate environment are another

²⁰ Consumer credit includes vehicle loans, credit card loans, renovation loans and lines of credit

reason for the growth in mortgage credit, which constitutes almost 70%²¹ of total household debt.

The financial situation of households remains healthy. Rising debt levels are supported by low debt-service costs, as a result of a continued low interest rate environment and ongoing growth in assets and income. The Bank of Canada Review in December 2003 reported that growth of household credit has been persistently strong in recent years, in sharp contrast to the sustained slowing in business credit.

The Canadian Federation of Independent Business Survey, October 2003 reported the SME sector accounted for close to half of Canada's GDP. While the size of the market makes it an important market segment for bankers, there are revenue opportunities that Canadian banks will also find attractive. In an article in Texas Banking, David Carden²² reported the reasons why US banks find small business attractive as follows:

- They use a variety of cash management services that generate daily fee income.
- Their high transaction volumes increase profit opportunities through increased per-item charges.
- They often use profitable electronic delivery products and services.
- They are likely to require products and services that reduce exposure to fraud.
- The financial industry continues to dominate the strategically valuable small business lending market.

²¹ Bank of Canada, Dec 2003, p. 5

²² Carden, Oct 2002, p. 14

- Small businesses tend to be two to three times more profitable than the average retail customer, according to the Bank Administration Institute.

2.2 The Participants

Before analysing the Canadian Financial Services Industry, it is important to understand the various players in this sector. This section will provide a brief description of the various participants in the Canadian Financial Services Sector.

2.2.1 Canadian Banking Industry

HBCA is a member of the Canadian banking system which is made up of 19 domestic banks, 29 foreign bank subsidiaries and 22 foreign bank branches. The structure of the Canadian banking system is characterized first by the presence of six very large domestic banks (better known in banking circles as the 'Big 6 banks') which control 87% of banking assets and 100% and 87%, respectively, of the trust and brokerage industry assets²³. Its second characteristic is the large number of international banks operating in Canada through a subsidiary, representative office or branch of the parent bank. International banks specialize in corporate and investment banking, often with only one or two offices/branches. A notable exception is HSBC Bank Canada which is a subsidiary of an international bank that has a network of 120 branches across Canada, thereby allowing it to provide the same range of banking services offered by the Big 6 banks.

²³ Bain & Co, Dec 2003,

Banks in Canada are governed by the Bank Act, which provides for three classes of banks based on ownership. Canada's domestic banks, which are headquartered in Canada, and widely owned (that is, with no one owning more than 10 per cent of all shares), are listed in Schedule I of the Bank Act. Canada's domestic banks are sometimes referred to by the Canadian public as Schedule I banks. Banks incorporated in Canada, but owned by foreign parent banks or other financial institutions, are listed in Schedule II of the Bank Act and are commonly known to consumers as Schedule II banks. Foreign bank branches not incorporated in Canada but carrying on banking business in Canada are listed in Schedule III of the Bank Act. The Schedule II classification was designed to accommodate foreign bank subsidiaries and impose restrictions in the number of branches and kinds of permissible activities a Schedule II Bank could conduct in the country.

Regulatory reforms over the years removed restrictions on the kind of business that the Schedule II banks can be involved in. Amendments to the Bank Act in 2001 replaced the Schedule I and II bank structures with a new size-based ownership regime. Under this regime, banks with equity greater than \$5 billion are required to be widely held, with no person owning more than 20 per cent of voting shares or 30 per cent of non-voting shares. Banks with \$1 billion to \$5 billion in equity are allowed to be closely held, subject to a public float of 35 per cent of voting shares, while banks with less than \$1 billion in equity have no ownership restriction other than a fit and proper test.²⁴ Notwithstanding the recent regulatory changes, banks in Canada are still better known and identified by consumers as Schedule I and Schedule II banks. Consumer perceptions,

²⁴ Department of Finance Canada website.

which are no longer valid, about the restrictions (on permissible activities or number of branches) on a Schedule II banks is an important consideration in determining the strategy for a Schedule II bank.

2.2.2 Investment Companies

Investment companies or securities dealers are regulated provincially and earn fees and commissions buying and selling stocks and bonds from or to individuals and companies. These companies are also involved in providing advice and underwriting public issues for companies that wish to raise funds to finance their capital expenditure programs. Today the majority of the large investment dealers operating in Canada are subsidiaries of the large chartered banks.

2.2.3 Credit Unions and Caisses Populaires

Canada's co-operative credit movement constitutes another segment of the financial services industry. The key players in this sector are the caisses populaires in Quebec and credit unions in the rest of Canada. Due to their small size and regional focus they have not traditionally been considered major players as they have focused on meeting the consumer loan needs of their members. However credit unions and caisses populaires are becoming increasingly active in the provision of wealth management services and loans to SMEs, especially in Quebec, British Columbia and Saskatchewan where they are particularly strong.

2.2.4 Finance and Leasing Companies

The finance and leasing sector allows for the financing of equipment and vehicles primarily by way of lease, but also by secured loan or conditional sales. While many finance companies are subsidiaries of manufacturers, or “captives,” assisting in the financing of their parent company’s products, more recently there has been significant growth in the number of independent companies.

2.3 Rivalry amongst competitors

The Canadian banking industry is highly competitive. Banks have been around in Canada for a long time, and just about everyone who needs banking services already has a relationship with at least one bank. In order to grow, banks in Canada need to lure customers away from competitors due to the small market size in Canada (a result of Canada’s small population relative to the size of the country). They do this by offering lower financing and investment services at preferred rates, a phenomenon that Porter suggests intensifies industry rivalry by creating a strong “temptation to cut price”²⁵. Lindsay Gordon, CEO of HSBC Bank Canada, remarked in an interview with Bloomberg.com that “Profit margins in (the banking industry) Canada are among the lowest in the world because of the fight for customers”²⁶ and the banking sector is in a race to see who can offer better and faster services. The pressure on interest rate spreads earned by Canadian banks illustrates the degree of rivalry e.g. spreads are a full percentage point below those in the US and the UK and over 4.5 points lower than in

²⁵ Porter, March – April 1979, pg 7

²⁶ Bloomberg.com, May 13, 2004

Germany. Additionally, market pressures are driving tighter margins, and there is also public and perceived political pressure to lower service fees and further narrow spreads. Consumers of financial services in Canada are more informed than ever before, in part due to technological advances. As a result they are demanding better service, more choice, and value from their financial services providers, meaning that Canadian consumers are able to obtain banking services at costs ranked among the most competitive in the world.

Competition in Canada's banking sector is driven by three major developments i) the old barriers that prohibited financial institutions from competing in each other's business have disappeared allowing banks to own investment dealers and insurance companies to participate in the Canadian payments system etc. ii) relaxation in regulation has opened the market to foreign financial services providers to operate in Canada, iii) technology has enabled banks to offer more products and services in new ways. Even though Canadian financial services providers try to adopt new ways to offer financial services, others can quickly and easily copy the services and product offerings, making them homogenous. The homogeneity increases the intensity of the competition as banks compete to gain market share in an already over crowded market that has limited growth opportunities.

HSBC Bank Canada is the largest Schedule II bank in Canada, but it considers the Big Six banks direct competitors due to its national presence and since it offers the same range of services as the Big 6 banks. Canadian banks have grown in size as a result of mergers and acquisitions that took place in the 1990s (which followed the disappearance of the four pillars of the financial services sector). Most of the acquisitions took place

within the financial services sector largely as banks acquired trust and brokerage companies. The Big Six banks are substantially larger than HBCA, but the question still remains whether size of a financial institution is important. Charles Freedman and Clyde Goodlet²⁷ have remarked

“Economies of scale clearly exist in certain parts of the operation of FSPs²⁸. However, empirical work thus far has provided no evidence that a bank has to be a mega-institution, rather than just large, to exploit most economies of scale. And, of course, some economies of scale can be exploited by outsourcing or by purchasing certain types of services from specialist institutions, as has happened in other industries and in the backroom operations of banks”.

Table 2 shows that HSBC Bank Canada is substantially smaller than the domestic Canadian Banks in terms of asset size but is more profitable than any of them.

Table 2: Key Financial Statistics of Canadian Banks

	Total Assets (\$ billions)	ROE (%)	Cost Income Ratio
RBC Financial Group	416,665	17.8	61.7
CIBC	284,938	21.0	65.5
TD Bank Financial Group	315,814	19.8	69.0
ScotiaBank	281,450	19.4	54.3
BMO Financial Group	265,394	18.3	65.0
National Bank	80,812	19.0	63.4
HBCA (Dec year end)	37,509	23.4	51.7
Other Domestic Banks	28,264	n/a	n/a
Foreign Banks	119,412	n/a	n/a
Total	1,792,749		

Source: Banks Financial Results 2004 Fiscal Year, Canadian Bankers Association, April 2004

²⁷ Bank of Canada, Technical Report, Aug 2002, p 11

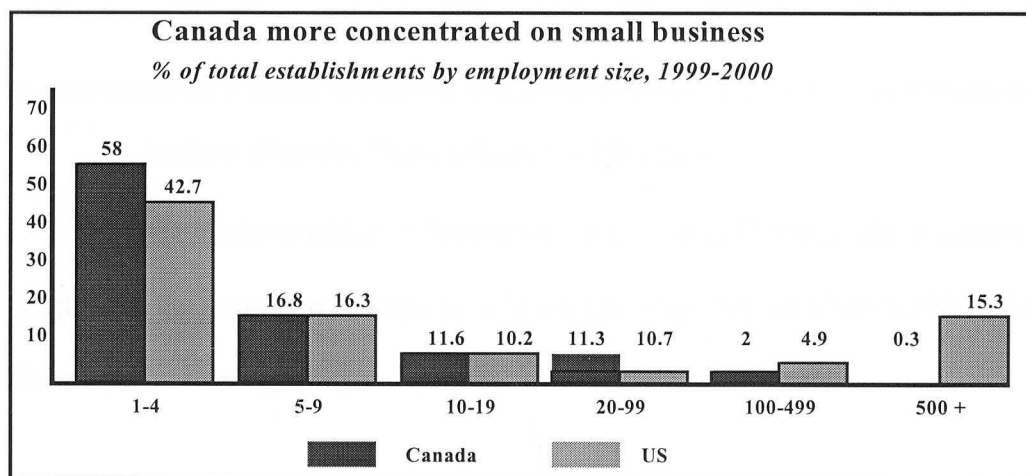
²⁸ Financial Service Providers

While competition from the Big 6 banks is fierce, HBCA is subject to the same regulatory requirements—especially those relating to the Basel capital adequacy ratios—as these banks. However other participants in the financial services sector, namely the smaller domestic banks, credit unions, finance and leasing companies, are not impacted by the requirements of the Basel II Capital Accord,²⁹ and are becoming increasingly active in HBCA’s market as the following discussion will illustrate.

2.3.1.1 Competition in the Small and Medium Enterprises Sector

Figure 2 shows that compared to the United States, very small establishments (with between one and four employees) account for a much larger percentage of business establishments in Canada³⁰. Estimates based on Statistics Canada data indicate that Canada’s SME sector accounts for close to half (45%) of gross domestic product.³¹

Figure 2 : Canada more concentrated on small business



Source: *The Path to prosperity: Canada’s Small and Medium-Sized Enterprises*, October 2002 p. 6

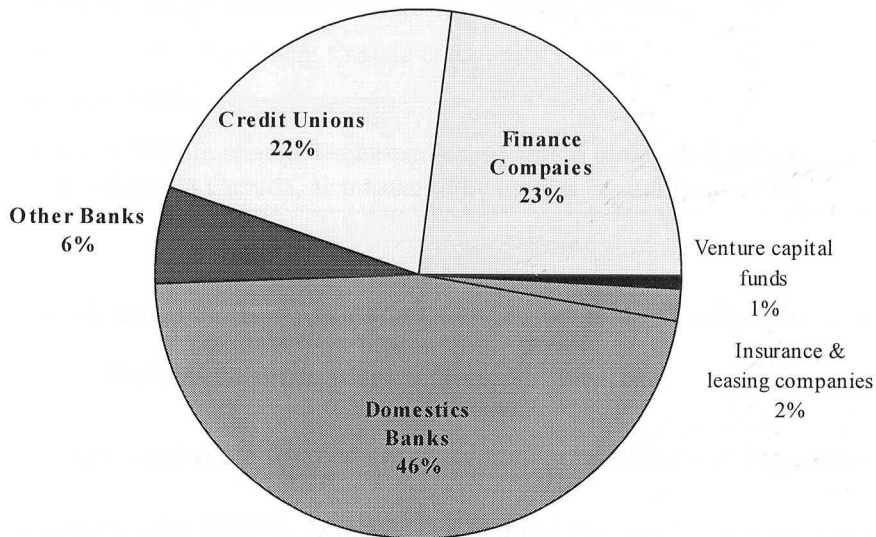
²⁹ The Capital Accord is only applicable to large international financial services organizations. In Canada OSFI has stipulated that an organization with capital greater than 5 billion dollars Canadian would be subject to the new capital accord.

³⁰ CFIB, CMA, RBC Survey, Oct 2002, p. 6

³¹ CFIB, Oct 2003, p 1

SME financing is available from banks, credit unions and caisses populaires, insurance and leasing companies and finance companies. According to the Statistics Canada Survey of Business Financing, in 2001 debt financing authorised to SMEs totalled nearly \$ 146 billion.

Figure 3 Firms with Credit Authorizations under \$1 million



Source: Canadian Bankers Association, Competition in the Canadian Small and Medium- Size Business Financing Market, December 2003, pg 3

While banks continue to hold a dominant share of SME credit at almost 52% (Figure 3), the number of competitors in the Canadian market place for SME financing in Canada is increasing. (Figure 4)

Figure 4: Competitors for Canadian SME Financing

COMPETITORS IN THE CANADIAN MARKETPLACE FOR SME FINANCING

In addition to the six largest domestic banks, there are a range of competitors including

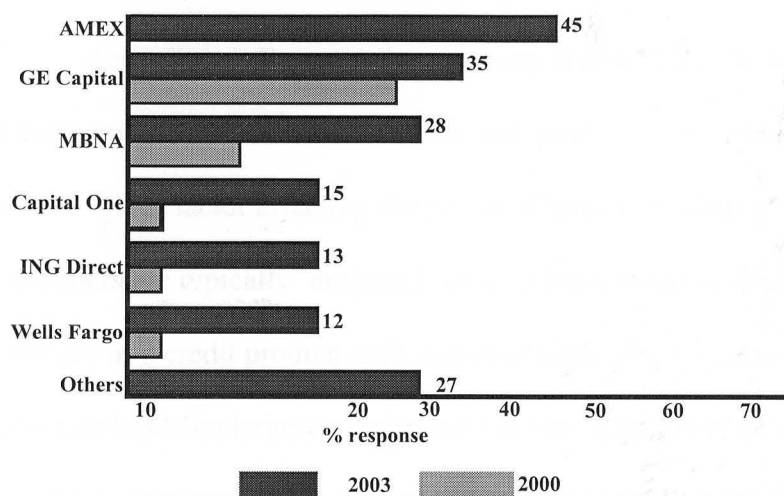
- 12 smaller domestic chartered banks
- Over 40 foreign-owned banks (as subsidiaries or foreign branches)
- 25 trust companies
- About 1,300 credit unions and caisses populaires
- Provincial government savings and lending agencies
- Over 100 independent finance companies
- Over 150 investment dealers
- Over 100 life insurance companies, of which three are in the top nine financial services providers in Canada, as measured by market capitalization

Source: Canadian Bankers Association, Competition in the Canadian Small and Medium- Size Business Financing Market, December 2003, pg 2

In recent years finance companies or subsidiaries of large international corporations like AMEX, MBNA, GE Capital etc. have increased their share of the SME credit market (Figure 5); however, as reported in the CFIB survey “use of specialized/foreign institutions has become more common, but it does not represent a full banking alternative for SMEs”³², and banks will continue to remain the first choice for SMEs provided they are able to remain competitive.

³² CFIB Survey, Oct 2003, p 6

Figure 5: SME financing by non banking sector



Source: Adapted from CFIB Survey on SMEs October 2003, pg 7

Advances in technology have made it easier for an SME to maintain its core banking services with a bank while obtaining loans from a provider that is more competitive and/or flexible. Basel II may blunt the competitive edge of banks as it requires a more accurate assessment of the true risk of a loan using a set of objective criteria, including validating performance against statistically valid industry benchmarks. It will therefore become increasingly difficult for bankers of small and medium enterprises (SMEs) to continue to consider soft facts such as market/industry position, competence of SME management, operating leverage, and so forth in their approval decisions.³³ Credit unions and finance companies that are not subject to Basel II requirements will have a competitive advantage over the banks in this respect.

³³ Bartels, Nov/Dec 2002, p. 48

2.4 Bargaining Power of Customers

According to Porter, ‘a buyer group is powerful if it is concentrated or purchases in large volumes’³⁴ The individual doesn't pose much of a threat to the banking industry, but one major factor affecting the power of buyers is relatively high switching costs. Customers are typically ‘anchored’ to their bank via their core bank account or the presence of a credit product such as a mortgage. The hold that a core account has on a customer has been largely convenience driven. The automation of many banking services has firmly anchored core accounts in place by increasing the hassle of moving them between banks. e.g. automated and post dated bill payments, and direct payroll deposit tie a customer to a bank.

If a person has his or her mortgage, car loan, credit card, checking account, and mutual funds with one particular bank, it can be extremely difficult to switch banks. In an attempt to lure-in customers, banks try to lower the price of switching, but many people would still rather stick with their current bank. While switching costs are high for a customer that obtains a full range of services from a bank, there are an increasing number of customers that obtain a single product or service from a bank. In fact the ease with which a consumer can obtain information on pricing of products and services increases their ability to shop for around for the cheapest price. Switching costs for such customers are extremely low, and it is not uncommon to find these kinds of customers negotiating with banks to obtain the best rate. Porter makes the observation that a buyer group is powerful if the products it purchases are standardized and undifferentiated.³⁵ Consumers

³⁴ Porter, Michael E 1998, pg 5

³⁵ Porter, Michael E, Mar – Apr 1979, p. 6

of financial services in Canada perceive products to be homogeneous in nature with little or no differentiating factors between products. Traditional banking products, once the staple products of a bank have become commoditized as products and services are homogenous in nature. New products and services are introduced regularly but are rapidly duplicated by competitors if they are successful.

2.5 Threat of Substitutes

There are plenty of substitutes in the banking industry. Banks offer a range of services over and above taking deposits and lending money. But whether it is insurance, mutual funds, or fixed income securities, chances are that there is a non-banking financial services company that can offer similar services. Barriers to entry for a firm offering services such as bill payment or ATM machines are low. On the lending side of the business, banks are seeing competition rise from unconventional companies; Sony, General Motors, and Microsoft all offer preferred financing to customers who buy big ticket items. If car companies are offering 0% financing, why would anyone want to get a car loan from the bank and pay 5-10% interest? Large unregulated competitors like GE Capital, and General Motors Acceptance Corporation now offer products like motor vehicle financing and equipment financing that are competitive substitutes for the loans previously borrowed from the banking sector.

While adding to the level of competition in an already crowded market, the growth of i) non traditional banking channels like the Internet and Interac provide alternate methods of withdrawing cash or transferring funds and paying bills, ii) non

traditional banking locations like President's Choice Financial Services at grocery stores offer Canadians the opportunity to bank and shop at the same location and iii) virtual banks like ING Bank are able to offer better returns and have increased the threat of substitutes in the banking environment in Canada.

2.6 Bargaining Power of Suppliers

The importance of scale in Canadian banking has created entities that offer back office processing services to the Canadian Banking industry. Companies like Moneris Solutions, the largest payment-processing entity in Canada and one of the largest in North America, increase their bargaining power as their size increases. Questions have been raised as to whether financial services providers would begin to develop common systems to support internal risk management processes or clearing settlement processes.

Employees are also considered suppliers of human capital to a bank. There is a threat of a bank losing its employees to others. If a talented individual is working in a smaller bank, there is the chance that that person will be enticed away by bigger banks, investment firms, and the like. Canadian banks and their subsidiaries directly employ more than 239,000 Canadians at July 31, 2002. Technological innovations in the industry mean that employees' jobs are no longer transaction-based but are knowledge intensive and aimed at enhancing customer relationships and creating value for the banks that employ them. Banks are therefore required to recruit employees with higher education levels, and the shortage of such labour has led to increased bargaining power for those employees that have the requisite education.

2.7 Potential Entrants

A changing regulatory environment and advances in technology (both of which will be discussed later on) are allowing large, international financial services giants, some of whom specialize in niche markets such as credit cards and discount brokerage, to bring considerable size and scale to Canada's competitive market for retail and commercial financial services. Foreign virtual banks like ING Bank or monoline credit card issuers like MBNA are finding it increasingly easy to set up operations in Canada. Wells Fargo Bank a couple of years ago started offering loans to small businesses from its offices in San Francisco. Loans restricted to a maximum of \$100,000 per borrower were authorised over the phone or the Internet. Wells Fargo has a strong competitive advantage of lower fixed costs by not maintaining a branch network in Canada. The key advantage that these new entrants have over the domestic banks is their ability to focus their marketing at a niche market. Wells Fargo, for example, targets small businesses and ING Bank targets only individuals with savings accounts, although recently ING Bank also started offering residential mortgages. Due to the low cost of business, these new entrants are able to be competitive and can gradually erode the market share currently held by the Canadian banks.

Lease financing is becoming an important source of financing for the SME sector as a result of tax benefits that lease financing offers certain borrowers. Of the \$16 billion

leasing market in 2001, banks financed only 9%, while finance companies like GE Capital and Ford Credit participated to the extent of 59%.³⁶

2.7.1 Legislative changes

The past decade has seen significant legislative changes in the financial services sector. The 1992 changes to the Bank Act collapsed the four pillars³⁷ of the Canadian financial services industry. Prior to 1992, each group operated in its own market and offered very specific products and services within their respective core business lines. With the removal of legislative barriers, large financial groups were set up in the banking and life insurance sectors, with each sector being able to offer products of the other resulting in a significant level of product convergence.

In 1999, legislation was passed that allowed foreign banking groups to set up branches in Canada. These branches face much lower regulatory requirements than domestic banks such as HBCA. The only restriction placed on these branches was their ability to take deposits to finance their operations. Full service branches cannot take deposits less than \$150,000, and limited service branches or lending branches cannot take deposits at all. These branches must borrow from other financial institutions at rates that are normally higher than rates paid to a bank's customer. The rationale behind the Government's policy is that if a bank does not take deposits, there is a limited need for the same level of regulatory supervision as domestic banks who receive the benefits of

³⁶ Canadian Bankers Association, Competition in the Canadian Small and Medium- Size Business Financing Market, December 2003, pg 4

³⁷ Four principal groups: Banking, investment, trust and insurance.

deposit insurance from CDIC³⁸. The implications of this policy is that banks like Wells Fargo may offer commercial banking services without the expense and effort of incorporating and capitalizing a Canadian subsidiary. The 1999 regulatory changes, allowing foreign financial institutions to set up operations in Canada has increased the number of competitors, and a number of monoline companies offering one product have emerged. Canadian banks, including HBCA, are being challenged to protect their existing customers and win new business from their competitors.

The 2001 legislation allows credit unions to set up a national services entity. No credit unions have as yet moved towards implementing the new framework, but it is reported³⁹ that Credit Union Central of British Columbia and Credit Union Central of Ontario have announced an intention to merge. Once this is done and others credit unions follow suit, banks could face an enhanced threat from the credit unions who will be able to seek the benefits of economies of scale, reduced costs and, more importantly, national level coordination instead of their current fragmented provincial operations.

2.7.2 Technology

Technology is dramatically changing the way most Canadians conduct their financial affairs. In the past decade alone, we've seen the introduction of Internet banking, electronic payment systems, 24-7 self-service, and debit cards, to name a few of the more significant advances. All have had a huge impact on the way banking services are delivered, the way we as consumers conduct our banking business, and the nature and

³⁸ Institutions that do not take deposits under \$150,000 or do not take deposits at all are allowed by legislation to opt out of the strict reporting and other requirements associated with CDIC membership.

³⁹ Daniel, Winter 2002-2003, p. 12

economics of the banking business itself. Canadians have been early and knowledgeable adopters of new banking technologies ever since the introduction of Interac's national Automated Banking Machine (ABM) network in 1986. Today, more than 85 per cent of retail banking transactions in Canada are conducted electronically through use of debit cards, telephone banking, online banking and hand-held wireless devices.⁴⁰ Technology has "provided individual business lines in banks other uniquely important advancements that have transformed those businesses: imaging and truncation in check processing; powerful analytical software for near-instant credit card and mortgage decisions; and application integration suites to tie it all together in real time"⁴¹.

To take advantage of the growth offered by technology and to meet the demands of their customers, Canada's big six banks have introduced new products and technology to wean customers from traditional services to electronic facilities. Having spent almost \$4.2 billion in technology in 2002, banks are spending even more as the future of banking moves to the Internet. Canada's big six banks view technology as the prime vehicle for reducing the high-cost bricks and mortar infrastructure.

Advancing technology generates pressures on Canadian financial institutions to become more efficient in their operations. It is now possible for a person to have an account with one financial institution and shop the balance of their businesses to others that specialize in the delivery of a particular product. Credit applications can be made from home, through online banking, and payments to any financial institution can be made directly from an existing bank via the phone/Internet or through pre-authorized

⁴⁰ Canadian Bankers Association, 2004

⁴¹ Kidder, Sep 2003, p 2

payments. With niche players entering the financial marketplace, such as virtual banks, and traditional banking products, such as residential mortgages, becoming commodity products, there is a growing need for a continued focus on becoming a low cost, 'best service' provider.

2.8 Government Regulations

The Canadian Financial Services industry is regulated either federally or provincially. The Office of the Superintendent of Financial Institutions ("OSFI") regulates banks and all federally incorporated or registered trust and loan companies, insurance companies, cooperative credit associations, fraternal benefit societies and pension plans. OSFI's website states as its mission: "to protect the rights and interests of depositors, policyholders, pension plan members and creditors of financial institutions, and to advance and administer a regulatory framework that contributes to public confidence in a competitive financial system".

Every bank in Canada is required to be a member of the Canadian Deposit Insurance Corporation, a federal Crown Corporation created in 1967 to provide deposit insurance and contribute to the stability of Canada's financial system. CDIC insures eligible deposits at member institutions (up to \$60,000 per depositor) and reimburses depositors for the amount of their insured deposits when a member institution fails.

All Canadian Banks are required to meet capital adequacy standards prescribed by OSFI. Two minimum standards have been established encompassing the guidelines established by the July 1988 Capital Accord by the Bank for International Settlements. The two standards that have been established are i) an assets to capital multiple where

total assets should be no greater than 20 times capital and ii) a risk based capital ratio where a bank's assets are assigned a risk weighting and each bank is expected to maintain minimum assets to capital ratio of 8%. OSFI requires all Canadian banks to comply with Basel II, which will be effective on January 1, 2007. Initial studies suggest a 30% reduction in the capital requirements for SME exposures managed in line with the more advanced approaches of Basel II.

The fierce competition in the Canadian Financial Services sector and large corporate loan losses require financial institutions, especially Canadian banks, to identify new markets if they want to grow their commercial banking business. In the current competitive environment financial institutions can achieve business growth by luring customers away from competitors. Banks can do this by offering cheaper interest rates or compromising credit terms and conditions. This approach is not sustainable in the long term and Canadian banks need to identify a sector that is growing. The SME sector is a significant part of the Canadian economy, contributing 45% to GDP, and has experienced substantial growth in recent years. The expected expansion of the SME sector will provide further growth opportunities. In addition, the capital benefits available under Basel II for lending to SMEs will reduce the amount of capital a bank has to maintain for a loan to an SME. The reduction in capital will allow a bank to offer more competitive pricing or increase the amount of the loan it is prepared to offer, both of which provide it with a competitive advantage over others.

3 VALUE CHAIN ANALYSIS AND STRATEGIC FIT

Michael E Porter developed the Value Chain in 1985 as a tool for identifying ways to create more customer value. Porter's model identifies nine activities that create value and cost in a business. The nine value creating activities consist of five primary activities – inbound logistics, marketing, distribution, operations, and customer service and four support activities – risk management, technology development, human resources management and firm infrastructure. Compared to the industrial value chain which starts from inbound logistics, the banking value chain starts from the customer side. First the product is brought to the market, then the product is sold or provided to the customer and finally the products of corresponding transactions will be executed.

3.1 Inbound logistics

Inbound logistics relate to the handling of goods that are brought into a company. In the case of a bank, it is other people's money in the form of deposits or funds from the institutional market. Funds raised through the branch network provide a diversified and stable pool of funds at a lower cost than funds raised through the institutional or interbank market. Canadian banks have extensive branch networks that allow them to raise funds from depositors at a relatively low cost. HBCA does not have the same huge branch network and funds its requirements from the inter-bank or institutional market, which theoretically is a more expensive cost of funding.

Funding costs to a bank in the inter-bank and institutional market are based on the credit rating of the borrowing bank. HBCA enjoys the benefit of being the subsidiary of one of most financially sound companies in the world and funding costs have not been an issue in recent years. Additionally, as part of a contingency to meet cash needs, HBCA can access the considerable resources of the HSBC Group and currently has a US\$300 million standby borrowing facility from its US affiliate⁴²

A SME does not always approach a bank to borrow and often needs to open a bank account to disburse and receive funds of the business. Increasing business with the SME sector will provide a valuable source of deposits for HBCA, thereby reducing less reliance on the more expensive institutional funding source. The cheaper source of funding should help improve HBCA's profitability.

3.2 Marketing

Marketing is defined as “the process of planning and executing the conception, pricing, promotion and distribution of ideas, goods and services to create exchanges that satisfy individual and organizational objectives.”⁴³

One of the objectives of marketing is the promotion of products and services to satisfy a customer's objectives or needs. Policies for communicating brand and image to promote the products and services are an important function. Product innovation and pricing advantages are increasingly difficult to sustain requiring a bank to rely upon its brand to promote its product. Canadians have grown to trust their domestic 'Big 6' banks,

⁴² HSBC Bank Canada December 2003 Annual Report, p 18

⁴³ Beckman, Kurtz and Boone, 1992, p. 7

partly due to the strong regulatory environment in the country but also because banks have, over the past century, spent effort and money to establish their brands that Canadians have come to associate with security.

Since 1998, HSBC Holdings Plc, (HSBC Bank Canada's parent) has been working to establish 'HSBC' as a unified brand for the HSBC Group, using HSBC and the Company's hexagon symbol as its marketing name everywhere it operates. This branding exercise was designed to achieve recognition for HSBC as one of the world's largest and most successful financial services organizations. In 2003 the HSBC brand debuted at number 37th in the Interbrand's Annual Ranking of 100 of the Best Global Brands, 2003 with a brand value of \$7.5 billion. A strong brand image gives HSBC a competitive advantage over its competitors as few organizations match HSBC's capital strength, its international coverage and its knowledge of local markets. Chris Crook Chief Executive Officer of HSBC-Australia said in 1998: "Our membership of the HSBC Group gives our customers confidence. It sets us apart from the competition" "A strong brand pays dividends in our relationships with our customers, and ultimately helps our bottom line. If customers have faith in the HSBC brand, they will give us a trusted role in their lives and help us build our business"⁴⁴.

Brand campaigns in Canada in 2002 and 2003 have achieved notable success in generating recognition and differentiation, and Canadian consumers are beginning to perceive HBCA as an alternative to the domestic banks. However, much remains to be done, since HBCA is still far behind the Big 6 banks in terms of familiarity with the general Canadian public Despite its network of over 160 offices across the country,

⁴⁴ HSBC press release, Aug 2003

HBCA is still referred to as a Schedule II bank with the assumed restrictions on the services it can provide. As the brand becomes firmly entrenched in the market, the HSBC brand will prove a significant asset in growing revenue from core businesses.

An important activity in the marketing process is understanding consumer needs and behaviour. One key to effectively market to small business says First Charter⁴⁵ marketing director Kevin Toomb is to change your mindset⁴⁶ Toomb explains that the lower end of the small-business market resembles the consumer market in behaviour and as a result he says that SMEs should not be looked upon as small commercial entities. Instead they should be viewed as a different breed of consumer, and in doing so the bank will adopt a different strategy for making money from this sector. A consumer mindset according to Toomb, means deposits first, fees second and loans last. This is a complete reversal from the approach for dealing with the corporate and middle market sector.

In response to the question ‘what does a small business customer want nowadays?’ Patrick D Redmond, President and CEO, Viking Bank Seattle Washington replied “when you come right down to it the most important thing they want is a relationship. They want a business banker that can help with their business problems”⁴⁷ In Redmond’s experience, when a SME owner has a business challenge he wants to take it to his banker, whether it involves a lending opportunity or not. SME owners may be willing to pay a higher interest rate and fees for a good relationship and to a bank that understands their business or takes time to understand their business.

⁴⁵ A financial services company with \$4 billion in assets based in North Carolina

⁴⁶ Bernstel, Sep 2003, p. 16

⁴⁷ Streeter, Mar 2003, p. 14

A survey conducted by the Canadian Federation of Independent Business in October 2003 found that small businesses in Canada are looking for the following from their financial institution

- Knowledgeable relationship managers
- Flexibility to deal with their financial institution i.e. in branch, telephone banking, Internet banking etc.
- Reasonable credit terms and conditions
- Value for service charges/fees paid.

HBCA ranked second in the survey, behind credit unions but ahead of the major banks, on the issue ‘understanding of my business’ which places it in a good position to develop additional business with the SME sector.

3.3 Distribution

Products can be distributed through a branch network or through alternate distribution channels like telephone banking or Internet banking. The use of varied distribution channels, managed in different but co-ordinated ways increases the value produced by the bank for itself and for its consumers. While HSBC’s branch network will remain a critical delivery channel, it needs to expand the market for Telephone and Internet Banking capabilities due to its small branch network relative to the Big 6 Canadian banks. The HSBC Group has determined that its e-commerce capabilities have been a differentiating factor in its ability to service the SME sector in the global marketplace. HBCA is also implementing a focused e-business strategy to enhance electronic delivery capabilities to not only provide more effective management of its

SME customer base but also actively market other products and services to customers while they transact online.

3.4 Operations

In the value chain model, the focus is on production and throughput in the transformation of inputs into products and services. Processing payments and loan applications are examples of processes that are considered operations in a bank. A bank creates value for itself and its customers by optimising the balance between value added for a service provided and the production, distribution and contact costs.

The traditional method of commercial underwriting uses labour intensive processes involving senior lenders that carry high personal costs. Due to the small value of an SME loan, traditional commercial underwriting processes often do not offset the fee and interest income that the bank will earn from the loan. One option available to a bank is to establish processing centres wherein all loans are approved and administered at one central location, since economies of scale reduce the per loan processing cost. A side benefit is that centralised processing takes this task out of the branch, freeing up relationship managers to sell other services to a customer, which in turn creates more value for the bank.

The need to analyse a company's financial statements is another important requirement in the traditional commercial underwriting process. In studying SME's in Germany, Joachim Bartels found that SME's financial statements are generally geared

towards a tax avoidance strategy rather than a business and investment strategy.⁴⁸ This is also true for Canadian SMEs and is one of the reasons why SME owners pledge their personal assets to secure loans to their businesses or take retail loans in their personal capacities to fund the business. Banks like HBCA will need to change their approach to underwriting if the SME business is to add value, and the steps that HBCA needs to take are discussed in the next chapter.

3.5 Customer Service

This is the preferred direction in banking public relations. “Service” covers means-of-payment; back office operations linked to administrative and account processing of operations, and especially the processing of incidents and risk management. After-sales service is often considered to be the crux of the bank-consumer relationship, and poor after sales service is the principal cause of the break-up of this relationship. Service excellence is a key differentiator for HBCA in Canada, and it has long enjoyed an enviable reputation for superior service in both the commercial and household credit sector. The 2002 Customer Service Index shows HBCA maintaining its lead over the Big 6 Canadian banks. HBCA scored highest among all banks on all four ‘overall’ measures – Overall Quality of Customer Service, Value for Money of products and services, Would Recommend Institution to Friends/Family and Degree to which Institution values my business. The results of the October 2003 SME survey⁴⁹ found that HBCA was the strongest amongst banks in terms of servicing the small business market. (Table 3) and had the highest retention rate (Table 4).

⁴⁸ Bartels, Joachim C, November/December 2002 pg 48

⁴⁹ CFIB Survey, Oct 2003, p. 2

Table 3 Ranking of Institutions based on satisfaction of SMEs

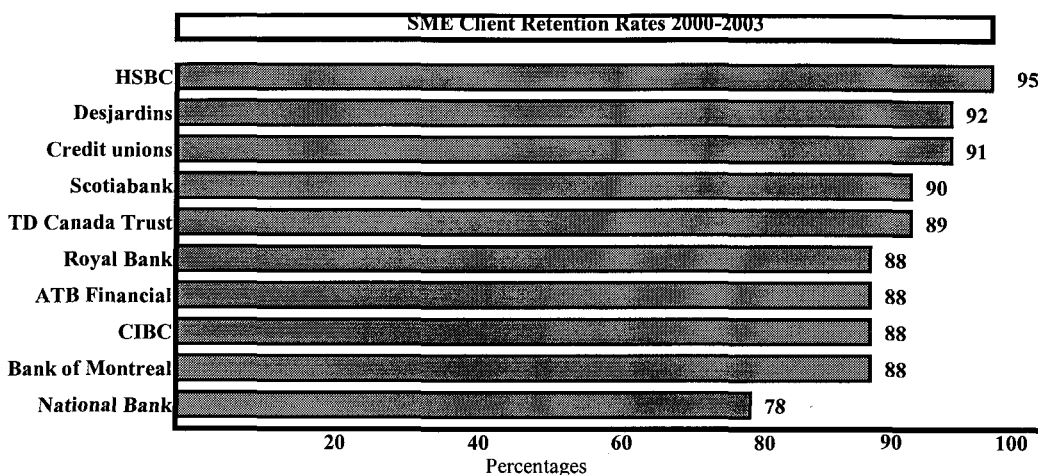
Ranking of Financial institutions, based on satisfaction of service quality									
OVERALL RANKING	Willingness to lend	Lending Terms	Information requirements for financing	Service charges	Understanding my business	Treatment by account manager	Distance to full service branch	Branch hours of Operations	Online banking
2003									
1. Credit unions	2	2	1	1	1	1	1	1	1
2. HBCA	1	1	1	2	2	1	8	4	7
3. ATB Financial	3	3	3	3	3	1	1	2	4
4. TD Canada Trust	7	4	6	5	7	5	3	2	1
4. Scotiabank	7	4	5	5	4	4	3	5	1
6. BMO	4	4	4	7	4	5	6	5	7
7. Royal Bank	5	4	6	9	7	8	3	8	4
7. CIBC	5	4	6	8	7	7	6	5	7
9. Desjardins	7	9	9	4	4	9	8	10	9
10. National	10	10	9	9	7	10	10	9	10

Source: Adapted from CFIB Survey on SMEs October 2003 pg 2

Customer Relationship Management:

Superior customer service provided through a relationship banking model has been a key factor in HBCA's growth in recent years, evidenced by a first ranking amongst Canadian financial institutions in Canada for customer retention (Table 4). The relationship banking model is premised on the intangible value of the unique "human-to-human" relationships between a bank and its clients. The relationship banking model has served the Bank very well and it has recorded strong year over year growth, one of the lowest loan loss provisions in the financial services sector, and the highest return on equity. Relationship Managers at the bank are customer-driven; they know their customers and tailor advice and solutions to meet their financial needs.

Table 4: SME Clientele retention rates 2000-2003



Source: Adapted from CFIB Survey on SMEs October 2003, pg 12

3.6 Credit and Risk Management

Risk Management is the identification, analysis, evaluation and management of the factors, which could adversely affect a bank’s resources, operations and financial results. HBCA has established formal risk management policies, which identify and analyse these risk elements and, where required, set appropriate risk limits. “Historically, our average percentage credit loss experience has been amongst the lowest of our peer group of major Canadian chartered banks.”⁵⁰(Table 5). Management attributes this to a strong control environment to ensure credit risks are appropriately managed through conservative lending practices, accurate recording, and strict approval and monitoring processes.

⁵⁰ HSBC 2003 Annual Report p. 20

Table 5: Loan Loss provisions in Canadian Banks

	Total Loans (\$ billions)	Non – performing Loans
RBC Financial Group	416,665	17.8
CIBC	284,938	21.0
TD Bank Financial Group	315,814	19.8
ScotiaBank	281,450	19.4
BMO Financial Group	265,394	18.3
National Bank	80,812	19.0
HBCA (Dec year end)	37,509	23.4

The low loan loss provisions indicate that HBCA’s risk management processes and policies have worked well, but they are inconsistent with the requirements of Basel II. Under Basel II banks with more sophisticated risk management systems and processes will require less capital and conversely those with weaker systems will require more capital. The steps that HBCA will need to take to implement more advanced risk management processes to manage the SME portfolio as well as satisfy the requirements of Basel II will be discussed in the next chapter.

3.7 Technology

A bank that wishes to compete effectively in the SME sector needs loan systems that are capable of handling huge volumes of loan applications and providing fully integrated functionality from origination to disbursement with capabilities to service and monitor loan positions in real time. To compete in the SME sector, a bank needs credit scoring and behavioural software to reduce the effort required to manage the smaller accounts. Credit scoring involves using variables input by the relationship manager, to

obtain an overall score from a decision support system that is compared against the predetermined thresholds to automatically refuse or accept of a customer's credit request.

Basel II requires banks to keep several years of transaction and loss data to develop and validate risk rating models that support an Internal Risk Based approach to calculating regulatory capital. Lee Kidder⁵¹ found that banks will have to adopt systems that have the firepower and scalability to collect, parse, aggregate, analyse, distribute, store and report on information.

HBCA systems are not currently compliant with the requirements of Basel II or the requirements to support the volumes of loans from the SME sector. In keeping with its customer service culture, technology enhancements at HBCA have been customer facing to ensure that customers are provided the latest technology. Internet banking, 24-7 self-service systems, electronic payment systems and debit cards to name a few significant advances. Internal systems and business process improvements have, however, been small-scale and incremental. As a result, business processes are labour and paper intensive, typically characterized by the following:

- A multitude of separate systems, each developed independently
- Wasted (and expensive) manual effort to re-enter information into multiple systems
- Customer information in multiple databases, frequently with inconsistent definitions
- Customer-level information not readily available
- No overall design or process integrity
- Excessive risk due to multiple handoffs

⁵¹ Kidder, Sep 2003, p 2

The steps that HBCA will need to take to implement more advanced risk management processes to manage the SME portfolio, as well as satisfy the requirements of Basel II, will be discussed in the next chapter.

3.8 Firm Infrastructure

Historically, the primary activity of a bank has been to act as an intermediary between two people and clear cheques issued by one in favour of the other. Canadian Banks have extensive clearing systems to handle the huge volumes of cheques that are issued by Canadians everyday. However check clearing and payment services are becoming commoditized, and there are limited opportunities for Canadian banks to differentiate themselves or develop any core competencies, other than what they already have. Efficiency gains can only be obtained through scale, and there is a growing trend for the Canadian banks to outsource such back office services to companies like Moneris Solutions, the largest payment-processing entity in Canada and one of the largest in North America. HSBC Bank Canada does not have the volumes to justify the costs to set up a cheque clearing system and therefore out sources its cheque clearing requirements to Bank of Montreal.

Domestic banks in Canada have been around for over a hundred years and have become the mainstay of the local economy with bank branches on every street corner in large Canadian cities. Over the years, banks have invested huge amounts in real estate to host these branches. While banks may have developed competencies identifying suitable branch location or designing branch layout, the declining demand for physical branches eliminates the need for banks to continue to build competencies in this area. Banks have

realized that the significant amount of effort devoted towards maintaining and renovating real estate properties can be more profitably diverted to the core banking business. A couple of years ago, Royal Bank of Canada announced the sale and lease back of its real estate properties to free up almost \$857 million to be deployed in its core banking business lines. Property management is now managed by the third party landlord freeing up resources for the core business. As a relative newcomer to Canada, HSBC Bank Canada has a limited branch network and its decision to limit its branch network and rent rather than own real estate is a result of the declining demand for the traditional 'bricks and mortar' style of branch banking due to rapid innovation in technology.

In conclusion, key success factors for a bank that wants to succeed in the SME sector include the ability to understand a customer's needs and the use of advanced risk management systems to efficiently process the large volumes of loans.

In the SME sector, HBCA is well positioned to take advantage of the opportunities because of a strong customer service culture. This core competency has allowed the bank to differentiate itself from domestic Canadian banks. Surveys that measure customer retention and understanding of customer's needs indicate that HBCA ranks the highest in comparison to other banks. Cultural and technological factors present challenges in HBCA's ability to handle the large volumes of customers available in the SME market. The steps that HBCA needs to take to address these challenges will be discussed in the next chapter.

4 STRATEGY INITIATIVES

The banking system in Canada is dominated by the Big 6 banks, which have advantages in economies of scale and established industry reputation. HBCA's generic strategy, as a differentiated player, is to focus on strong customer service, offering customer versus product oriented solutions to capture a greater share of the wallet e.g. packaged or bundled products/services to meet overall needs and provide greater convenience and flexibility.

HBCA's core competency is its strong customer service culture. The Bank has a competitive advantage in that an inherent service culture has been ingrained in its staff for many years. HBCA has established a strong reputation in the industry as a result of this focussed strategy. To date, HBCA has differentiated itself, and has ranked highest amongst Canadian banks in various surveys, by responding to the marketplace's need for knowledgeable relationship managers that offer value added solutions, deliver quick turnaround, and provide value for fees and interest rates paid.

HBCA has also built competencies in a strong credit and risk culture, policies and procedures, which have translated into low loan loss provisions compared to the other Canadian banks.

As mentioned in the opening chapter, HBCA is pursuing a growth strategy to expand and build on its strengths as a financial services provider to small and mid-sized companies, which includes the SME sector. Bank of Canada studies indicate growth in

the SME sector to be better sustained than the large corporate sector and studies by the Canadian Federation for Independent Business indicate that SMEs contribute 45% of Canada's GDP, making it a significant contributor to the Canadian economy. Capital benefits are available, under Basel II, for lending to SMEs and are just another reason why HBCA should focus its efforts to growing business from the SME sector. This chapter will provide recommendations for HBCA to grow its business from the SME sector without changing its differentiated strategy of focusing on strong customer service and offering customer oriented solutions.

4.1 Segment Management

Currently HBCA's Commercial Banking segment (Table 6) is a single group of customers comprising borrowing accounts and non-borrowing accounts. The part of the segment where loan authorizations are below \$ 5,000,000 comprise the middle market segment and the segment where loan authorizations exceed \$ 5,000,000 comprise large corporate and treasury customers. Both segments are managed by Commercial Relationship Managers, and all customers receive the same treatment for assessing and approving credit applications, and the same level of customer service. Further HSBC does not differentiate between SME accounts and Middle Market accounts. The discussion below provides reasons for creating a separate SME segment.

Table 6: HBCA – Commercial Banking Segment Authorizations

	Number of customers	% of total	Total SME ⁵² customers available in Canada *	% of total
Middle Market				
0-\$99,999	10,052	47	1,625,600	77
\$100,000 to	5,873	27	356,900	17
\$500,000 to	1,793	8	57,600	3
\$1,000,000 to	2,533	12	51,100	2
Large Corporate and Treasury				
\$5,000,000 and	1,380	6	16,900	1
Non Borrowing	50,000			

Source: HSBC Bank Canada in the Community 2003

* Source: Survey of Suppliers of Business Financing 2002, Statistics Canada

The SME market, as a whole, has several characteristics that distinguish it from middle market accounts, which affect service packages, pricing and sales effort for this market. Within the SME segment, the lower end of the small business market resembles the household credit market in buying behaviour for banking services and repayment performance on loans. To ensure that the level of customer service (which includes knowledge of products required by the segment) and credit analysis is commensurate with the income earned and needs of the relationship, it is recommended that the HBCA's Commercial Banking segment be divided into segments shown in Table 7.

⁵² Based on amount of debt authorized by a financial institution to the SME in 2002

Table 7: Recommended Commercial Banking Segments

Segment	Total Loans authorised	Number of customers in segment *	Suggested branches
Middle Market Customers	> \$500,000	5,706	Vancouver, Calgary, Edmonton, Toronto, Montreal
SME – Small Business	\$100,000 to \$499,999	5,873	All branches
SME – Micro-business	\$0 - \$99,000	10,052	All branches
Non - borrowing		50,000	All branches

* Source: HSBC Bank Canada in the Community 2003

Non-borrowing accounts are accounts that a business maintains with a bank, where the main borrowing relationship is with another financial institution, typically a credit union, finance company or leasing company. The declining market share in SME loans of the Big 6 banks⁵³ indicates that an SME's financial requirements are being financed by loans from leasing or finance companies, or consumer loans in the owner's name. An account is opened with HBCA, either because the leasing company or finance company cannot offer the core banking services that HBCA offers, or the credit union cannot provide the international banking services that HBCA offers. These accounts are normally in the micro-business or the SME category, and are managed by HBCA on a reactive basis i.e. the account only receives attention if an irregularity needs to be addressed. HBCA's Commercial Relationship Managers have little to no appetite for managing such accounts, since the manual processes that they use take away from the time that could more profitably be spent with a larger account. Non-borrowing accounts, however, present a good source of cross sell opportunities, especially since the account

⁵³ CFIB Survey, Oct 2003, pg 7

may be borrowing at another financial institution. In HBCA, the non-borrowing segment appears to be growing at a faster rate than borrowing accounts, and they present internal opportunities for the bank to grow its business, either in the form of loans or cross sale of Personal Financial Services products to the owners or staff of the business. Tools for dealing with these accounts on a proactive basis will be discussed later in this chapter.

It was stated earlier that Commercial Relationship Managers manage all accounts within the Commercial Banking segment. Consideration should be given for relationship management of the Micro-business segment to be transferred to Personal Financial Services (“PFS”) Relationship Managers (“RM”) for the following reasons:

- Micro-businesses offer large potential to grow the bank’s PFS business, since a loan to the business could also result in loans to the business’ owner and staff.
- Micro-business accounts behave in the same manner as household credit accounts managed by PFS RMs. ANZ Bank New Zealand found that in the SME market, ‘decisions people make about their businesses also affect their lives’,⁵⁴
- Micro-business loan applications need to be processed using scoring technology that PFS RMs are comfortable with.
- Commercial RMS have little or no knowledge or interest in cross-selling the business’ owner PFS products like residential mortgages, vehicle loans, RRSPs and other wealth management products.

⁵⁴ Story, Nov 2002, p. 32

It is not sufficient for only Account Relationship Management to be transferred to PFS RMs. The different mindset required for dealing with the SME as a different breed of consumer is not only applicable from a relationship management point of view, but also when it comes to processing loan applications. Wendel and Harvey commented in their article in Commercial Lending Review that, “in instances in which the commercial banking area has responsibility for small business loans, a high level of concern exists over the use of scorecards. These lenders are used to custom approaches to lending and resist for cultural reasons more than others, relying on a score provided by an outsider.”⁵⁵ HBCA could learn from ANZ Bank New Zealand’s approach to their SME business. ANZ set up a small to medium business division making a promise to provide their SME customers 100% professional care. Following the example set by ANZ, HBCA should consider transferring its SME customers into a separate division managed by a Senior Executive, whose core responsibility is to develop and grow the SME business in Canada, as well as to address some of the cultural changes that will be discussed later on.

4.2 Introduction of scoring methodology

Chapter 3 discussed the importance of scoring technology and methodology to provide efficiency gains in dealing with the SME sector. The other benefits provided by the introduction of scoring technology in HBCA are discussed in sections 4.2.1 to 4.2.4.

4.2.1 Increase focus on marginal accounts

Automated credit scoring should not replace strong risk management practices, but scoring can play an important role in highlighting priority segments and in screening

⁵⁵ Wendel and Harvey, May 2003 p. 4

customers for increased focus. Scorecards rank by risk⁵⁶ allowing a bank to increase judgemental focus on marginal accounts. Fair Isaac Corporation, the leading developer of scorecards and models in North America, recommends that a bank's portfolio be divided into three groups based on risk. Those in the highest category are low risk and can be approved automatically. Those in the lowest category can be declined automatically, allowing a relationship manager to focus on the middle segment and make a judgement on credit worthiness.

4.2.2 Proactive management of non-borrowing accounts

Scoring will allow HBCA to deal with the huge number of non-borrowing accounts in a more efficient and proactive manner. Behaviour scores are scores computed based on an account's historical performance, which might predict the probability of the account going bad over the foreseeable future. Using policy based review rules, the credit scoring system could recommend an appropriate credit limit for the non-borrowing account. As previously stated, SME owners often fund their businesses with consumer loans if the owner is creditworthy. Using a combination of a behaviour score on the non-borrowing account with the credit score of the owner, HBCA could determine a credit limit that could be authorised in the name of the business and approach the SME business with an offer. This would not have been possible in a manual environment, which is the reason for these accounts being historically managed on a reactive basis instead of proactively.

⁵⁶ Latimer, Spring 1997 p. 18

4.2.3 Complement overall marketing and underwriting effort

The following example was provided, by Wendel and Harvey, to illustrate how credit scoring complements overall marketing and underwriting efforts.

A bank in the Northeast US runs a scoring model on a prospective borrower. Using the decision from the scoring model, the banker makes a personal visit to the borrower, even for a small loan of \$25,000, because the visit becomes an opportunity for the bank to capture a higher percentage of the customer's wallet share which is in line with HBCA's differentiated strategy to increase the share of a customer's business. The bank uses the personal visit as a sales call and a way to differentiate itself from other players. It is common for customers to receive by mail, on a frequent basis, letters from financial institutions pre-approving them for loans and credit cards for pre-determined amounts.

HBCA's current relationship management model is structured to allow RMs to spend more time with their customers, but this is efficient for the larger value relationships. Visiting borrowers of small loans is not efficient in the current manual environment at HBCA, because of the amount of paper work to process such loans. Using scoring methodology and technology, through Internet browser access from a laptop, RMs will be able to process a loan application from a customer's premises.

4.2.4 Accrue benefits from Basel II

Basel II requires a bank's rating system to be used for all credit approval, account management, internal capital allocation and corporate governance activities. HBCA's IT systems were designed many years ago to process transactions, not to collect the kind of

data that Basel II requires. The introduction of scoring systems will allow HBCA to use more objective and consistent methods for analysing prospective borrowers, to streamline the credit process and to automate the application of credit policy standards. In doing so, HBCA will meet one of the requirements of Basel II and obtain capital relief for its SME portfolio

4.3 Scorecard development

Latimer Asch⁵⁷, Vice President, Commercial Products, Fair, Isaac and Company, Inc, San Raphael, California provides the following requirements to develop a scorecard.

- Large amounts of data collected from thousands of good, bad and declined applications are required to build a good small business model. It is not just the good accounts that need to be analysed but also the accounts that defaulted or were declined by the bank.
- A number of characteristics, including ownership structure, sales size, geographic region, and amount of credit requested are analysed to develop the predictive power of a scorecard.

Scoring technology is important to HBCA's ability to grow its SME business, but its small SME portfolio, excellent loan loss experience and lack of internal bank information on customers present hurdles to its ability to develop a scorecard for its SME business; however, if HBCA wants to compete in the SME business and obtain the benefits available under Basel II, it needs to make a start. An option that Asch suggests is

⁵⁷ Latimer, Spring 1997 p. 18

for HBCA to use a generic scorecard that uses characteristics and data from other banks and assign conservative weights to the various characteristics in the scorecard to expose the bank to the least amount of risk. The Bank can adjust the weights once the scorecard is validated against the Bank's own experience using the scorecard.

4.4 Cultural Change

The amount of cultural change that entry into the SME market requires for HBCA that boasts of a strong relationship management model and low loan loss provisions should not be underestimated.

According to Lee A Kidder,⁵⁸ relationship banking is premised on the intangible value of human-to-human relationships, and there is fear that too much automation (key to the survival for any bank financing SMEs) would jeopardize the one-on-one judgement and flexibility such relationships depend upon.

Another area of cultural change explained by Kidder is the notion that credit and commercial lending are highly specialized skills, practiced and honed over years of experience, with so many complex nuances and variables that they cannot be effectively automated. HBCA should expect to face a huge amount of resistance from lenders who have long used soft facts about management, length of relationship, and so forth to justify credit applications and will be uncomfortable accepting a decision from a 'black box', the decision support system. Lender involvement in the scorecard development process will go a long way to developing 'buy-in' and acceptance. Through the score model

⁵⁸ Kidder, Sep 2003, p. 2

development process, lender representatives will learn that the same characteristics used in traditional commercial underwriting are used in score models. Additionally, providing the lender with the ability to reject a recommended limit from the decision support system will go a long way to developing confidence in the new process. Experience from the introduction of a similar process in the PFS business indicated only a 5% rejection of limits recommended by the decision support system. Short term success should not be expected to overcome the resistance, and the period required to develop buy-in could be a two-three year period, a time line that fits in well with the Basel II implementation date of January 1, 2007.

HBCA's relationship banking model has also meant that relationship managers have customized products and services to suit a customer's needs, which may be one of the reasons for HBCA's high ranking in SME surveys. The flexibility of credit limit structures and product combinations are often as complex as those offered to middle market customers, who are willing to pay for the complexity.

In the SME segment, especially the micro-business segment, the sheer number of customers with diverse needs makes customer support a huge undertaking. In catering to this segment, HBCA must offer products that are easy to sell and implement, as in retail they must be easy to use so as to ensure no flood of customer service calls. In defining its strategy for the SME sector, HBCA will have to radically change its processes, procedures and workflows around the new technology being introduced.

4.5 Distribution channels

Branches are the primary delivery channel for small business since the SME customer is interested in meeting with his relationship banker and discussing business issues, whether it involves a lending opportunity or not. With a national presence and only 120 branches, a challenge exists for HBCA and efforts are ongoing to expand the branch network by acquiring new branches. In 2004, HBCA acquired 11 branches when Italian Intesa Bank decided to stop doing business in Canada. In an interview with Bloomberg.com in May 2004, HBCA's CEO expressed HBCA's interest in growing its branch network in Canada to around 250 branches by 2009. In the meanwhile, efforts must be made to increase penetration of alternate delivery channels, since scoring technology and methodology can be easily implemented through channels such as online and telephone banking. A focused e-business strategy enhancing electronic delivery capabilities to provide more effective management of its SME customer base, as well as to actively market other products and services to customers while they transact online, is a strategy that HBCA could employ to continue to differentiate itself from other financial service providers in Canada. The e-commerce strategy should not be limited to providing information on products and services or account balances, but also to provide the tools for a customer to create and submit an online application for an SME loan (s), with formal approval to take place following a meeting with an HBCA RM to complete loan documentation.

HSBC has built a reputation in the SME market due to its strong relationship management model. Andrew Dinsdale, chairman of KPMG's Banking and Finance Group, expressed a concern that is being heard in certain circles at HSBC: using scoring

models to evaluate SME facilities could mean that “value judgments about potential borrowers are being made via an impersonal call centre”⁵⁹. HBCA is in the process of redefining its commercial branch network by establishing large commercial branches to manage complex commercial business and designating certain branches as purely retail branches. Assigning the SME relationships to these retail branches will ensure that relationship managers continue to meet with clients to discuss their banking requirements using scoring technology merely as a tool to manage the most basic analysis.

4.6 Choice of technology

Different technology is available in the North American market. It is either being developed or is in use by HBCA’s affiliates in Hong Kong and the United States. While the long term benefits of introducing new technology are evident from earlier discussions, the short term pain that will be imposed on relationship managers should not be underestimated. As stated in the earlier paragraph, any new technology should simplify processes and assist in handling the huge amounts of small value credit applications that are available from the SME business sector.

The introduction of technology cannot however be made without changes to business processes, and the following strategic decisions will need to be taken that will impact the choice of technology:

- Who should manage the SME business? As discussed earlier two options currently exist; the SME - micro business segment to be managed by PFS

⁵⁹ Story, Nov 2002, p. 31

relationship managers and the SME – small business segment be handled by commercial relationship managers.

- How important is the need to collect data from the perspective of i) the regulators who require three years of data prior to the implementation of Basel II on January 1, 2007 and ii) the Bank's own need to have sufficient data to validate scorecards used in scoring models?

If the SME – micro business is to be managed by the PFS relationship managers, then it will be beneficial to amend the PFS application system to meet the requirements of the SME – micro business, so that PFS users are presented with one front end that they are comfortable with. Additionally, it is expected that since a SME- micro-business behaves like a consumer, scorecards used in the PFS business may be used to evaluate loans to SME-micro businesses, with minor adjustments.

For the SME – small business segment, it is recommended that technology be introduced in two phases. Phase I will involve the implementation of a simple front end application that will be browser based and will allow relationship managers to input application data that will be captured in a database that can be used for future model portfolio analysis and model development, as well as meet the requirements of OSFI regarding data history. Using the format of current applications will ensure minimal impact to users as a result of a change to processes. Phase II will involve implementing more permanent technology being used by HBCA's affiliates in the US and Hong Kong.

In the Bank's current Managing for Growth environment, with the large business targets that have been assigned to branches, line managers see the Basel project as little more than a costly compliance exercise. It is imperative that any necessary infrastructure

improvements be leveraged by front line applications, and that all new systems, segmentation and risk inputs be used in the day-to-day management of the business which is also one of the requirements of Basel II. HBCA should use the rationale suggested by Lee Kidder ⁶⁰ and view Basel II as an opportunity to accelerate adoption of Risk Management best practices. As a related matter, it should implement strategic technology initiatives related to operational efficiency, straight-through processing, real-time processing, customer relationship management, channel integration, and outsourcing, all arguably because of their beneficial impact on capital reserve requirements.

The SME sector comprises two segments: the micro business segment and the small business segment. The micro-business segment comprises customers whose borrowing needs do not exceed \$100,000. The small business segment comprises customers whose borrowing needs range from between \$101,000 and \$500,000.

While the processes for dealing with customers and the level of earnings from both segments are similar, it is recommended that HBCA expand its business to the micro business segment for the following reasons:

- The customer segment is the largest segment of business borrowers in Canada, representing 77% of all Canadian business borrowers. (Table 6)
- The lower end (by loan size) of the SME market behaves in the same manner as household credit accounts managed by HBCA Personal Financial Services (PFS) Group.

⁶⁰ Kidder Sep 2003,p. 2

- HBCA's current 'Managing for Growth' strategy includes growing its PFS business. Micro business customers offer large potential to grow the bank's PFS business, as a loan to the business also results in loans to the business' owner and staff.

To succeed in the micro business sector HBCA will need to continue its existing competitive strategy. This includes focusing on strong customer service and offering customer versus product oriented solutions to capture a greater share of the customer's wallet. The following specific implementation initiatives should be taken to make the competitive strategy work:

- Segment the commercial banking business to create a SME micro business segment that comprises customers whose borrowing needs are less than \$100,000.
- Transfer account management of this segment to PFS relationship managers
- Introduce scoring methodology and technology to efficiently process the volumes of loans available in the SME micro business segment.
- Expand distribution channels by increasing the number of branches with an enhanced e-business offering.
- Appoint an executive to oversee a new division that will manage the SME business. The executive's core responsibility will be to develop business from the micro business segment and address the large cultural change that HBCA will face.
- To manage cultural change issues, HBCA should clearly communicate
 - the background and reasons for the change
 - how the strategy to expand business in the SME sector is in line with the Bank's Managing for Growth Strategy
 - how HBCA's previous reputation in the SME sector will ensure success

- how the introduction of leading edge technology will allow HBCA retain its reputation in the SME sector and make it easier for relationship managers to manage the huge volumes of SME customers

5 CONCLUSION

HBCA is a member of the Canadian Financial Services industry, an extremely competitive sector encompassing rivalry from other domestic banks, foreign banks and a range of finance and leasing companies. HBCA is a full service bank that has 120 branches across Canada.

The global banking system is undergoing significant change as a result of new rules affecting the methodology used by banks to calculate regulatory capital. The 'one size fits all' method of the current rules is simple and focuses on credit risk. The new framework being introduced by Basel II will relate regulatory capital more closely to the underlying risks involved, including credit risk, market risk and operational risk. It is clear that banks that adopt the more advanced approaches to calculating regulatory capital will be required to maintain less capital. As well, initial studies suggest a 30% reduction in regulatory capital for retail exposures, including SME exposures. Basel II is applicable to all large international financial institutions. In Canada, the Office of the Superintendent of Financial Institutions requires all financial institutions with capital in excess of Canadian Dollars 5 billion, to comply with the requirements of Basel II. Although below the Canadian Dollars 5 billion threshold, HBCA is required to comply with Basel II as a result of being a subsidiary of a large international financial institution.

The SME sector is a significant part of the Canadian economy, contributing 45% to GDP. The sector has experienced substantial growth in recent years as a result of strong consumer confidence growth, strong real estate markets and strong auto sales.

Large corporate loan losses in recent years as well have caused banks to focus their efforts on the household and small and medium enterprises sectors.

The expected continued growth of the SME sector, along with capital benefits available under Basel II for lending to SMEs, are reasons for HBCA to pursue SME business. HBCA is well positioned to take advantage of the opportunities available from the SME sector because of a strong customer service culture. This core competency has allowed HBCA to differentiate itself from the domestic Canadian banks and rank highest among the banks in various surveys, the most recent being the October 2003 survey by the Canadian Federation of Independent Business for banking services to the SME sector.

Certain challenges exist, both culturally and technologically, to HBCA's ability to handle the large volumes of customers available in the SME market. In keeping with its customer service culture, HBCA's technology platforms have been focussed more on meeting customer requirements than on managing the bank or its credit portfolio. HBCA's systems are not compliant with the requirements of Basel II or with the requirements to support the volumes of loans from the SME sector. Now however, there are business reasons for HBCA to upgrade its technology and enter the SME market if it is to meet its 'Managing for Growth Strategy'. Basel II should be viewed as the opportunity to accelerate adoption of more advanced risk management systems and technology.

Despite its small size in Canada, compared to the Big 6 banks, HBCA has over the years, overcome all obstacles presented by its small size to build a business in Canada that is in direct competition to the Big 6. It is recognized by customers, especially in the SME industry, as one of the top banks when it comes to offering customer service and understanding a customers needs.

The entry into the SME will involve a huge amount of cultural change for HBCA. The introduction of scoring technology will require changes to the method of assessing credit risk and remove, to some extent, the Relationship Manager's flexibility to offer product and services to their customers. However given HBCA's ability to adapt to change, that has been demonstrated by it successfully adapting to the different cultures of the banks it acquired over the years, and its reputation among the SME sector, its success is inevitable.

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