

**THE NEXT STEP IN SMALL AND  
MEDIUM ENTERPRISE LENDING**

by

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B. Com., University of British Columbia, 1997

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## **ABSTRACT**

This project examines the business lending industry in Canada and the strategic direction of the small and medium enterprise (SME) lending business of the Toronto-Dominion Bank Financial Group (TDBFG). TDBFG is one of the largest schedule I banks in Canada, however its market share of the SME lending market is substantially less than its market share in other business segments.

This paper will assess the current environment in which the Bank operates and identify key success factors in the SME financing business. It will then present TDBFG's optimal strategy going forward as well as an alternative strategy. An evaluation of TDBFG's current internal capabilities will determine whether the Bank is capable of executing the optimal strategy or should instead undertake alternative strategy. Presently the SME customer category is served by both the small business banking arm of the TD Canada Trust and the TD Commercial bank and as a result any recommended solutions will focus on these two business units.

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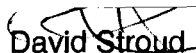
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### **Title of Thesis/Project/Extended Essay**

The Next Step in Small and Medium Enterprise Lending

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\_\_\_\_\_  
Date

08/10/2004

## **DEDICATION**

This paper is dedicated to Isabelle. My work over the past two years pales in comparison to her love, hard work, dedication and sacrifice throughout my lifetime in her unrelenting drive to help me realize my potential. My dream is to make her proud.

## **ACKNOWLEDGEMENTS**

Over the past two years many individuals have provided encouragement and support towards the attainment of my degree and completion of this program. First I would like to thank my best friend Ed Fidler and brother Chris Stroud for your support, encouragement and friendly rivalry. I thank John Stroud-Drinkwater for his efforts to assist me through the last stretch. I thank my two managers throughout the program, Jim Yee and Ruth Lee for providing support towards my endeavour and acknowledging my efforts in furthering my education. Finally, I thank my team members, cohorts and professors through whom I acquired my knowledge and sharpened my critical thinking.

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## **GLOSSARY OR LIST OF ABBREVIATIONS AND ACRONYMS**

ACC	Area Credit Centre
BMO	Bank of Montreal
BNS	Bank of Nova Scotia / ScotiaBank
CIBC	Canadian Imperial Bank of Commerce
CRM	Customer Relationship Management
ERP	Enterprise Resource Planning
FA	Financial Advisor
FSR	Financial Service Representative
GDP	Gross Domestic Product
GRM	Group Risk Management
HSBC	Hongkong and Shanghai Banking Corporation
MCC	Manager Commercial Credit
MSBBS	Manager Small Business Banking Sales
RBC	Royal Bank of Canada
ROI	Return on Investment
SBA	Small Business Advisor
SBB	Small Business Banking
SME	Small and Medium Enterprise
TDBFG	Toronto-Dominion Bank Financial Group
TDCT	TD Canada Trust

# **1 CHAPTER ONE: SMALL & MEDIUM ENTERPRISE LENDING AT THE TD BANK FINANCIAL GROUP**

Although the TD Bank Financial Group (TDBFG) has a robust 20.05 percent market share in the Personal Banking arena, its share of small enterprise lending is 10.9 percent and medium enterprise lending is 9.2 percent.<sup>1</sup> This represents a very large opportunity to the TDBFG because it implies that many of its personal customers have business dealings with other Canadian banks and that they can potentially be cross sold business financing. It also represents lost opportunities in the past, since the Bank has had a smaller market share in the SME market for some time and its current strategy has failed to close the gap. The Bank's leadership has recognized the value of this opportunity and has appointed an Executive Vice President, Bernard Dorval, to preside over this market segment in addition to the insurance group, as both of these markets have been identified as high growth opportunities for the Bank.

This paper will examine the competitive environment in the SME lending market and recommend an optimal and alternative strategy for TDBFG to execute, both of which could bring a bank success in gaining SME lending market share. Given these strategies, an audit of TDBFG's internal capabilities will qualify which strategy TDBFG is capable of executing successfully.

## **1.1 The Toronto Dominion Bank Financial Group**

The Toronto Dominion Bank Financial Group was originally founded in 1955 as the Toronto Bank, which in 1955 amalgamated with the Dominion Bank, which was chartered in 1869. Since its inception, the Bank has grown through organic growth, as

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<sup>1</sup> Market share statistics represent a percentage of customers dealing with Canadian chartered banks and deal not include non-bank financing to the SME market.

well as mergers and acquisitions. Most recently the Bank purchased CT Financial Services Inc., which vaulted the Bank from 5<sup>th</sup> largest bank by asset size to 2<sup>nd</sup> largest, behind the Royal Bank. Over time, the Bank has also broadened the scope of financial products offered and as a result has become a group of companies selling financial services to retail and institutional customers in Canada and abroad.

TDBFG has over 51,000 employees and more than \$316 billion in assets. As seen in Figure 1, it is comprised of three key business areas: Personal & Commercial Banking, Wealth Management and Wholesale Banking.

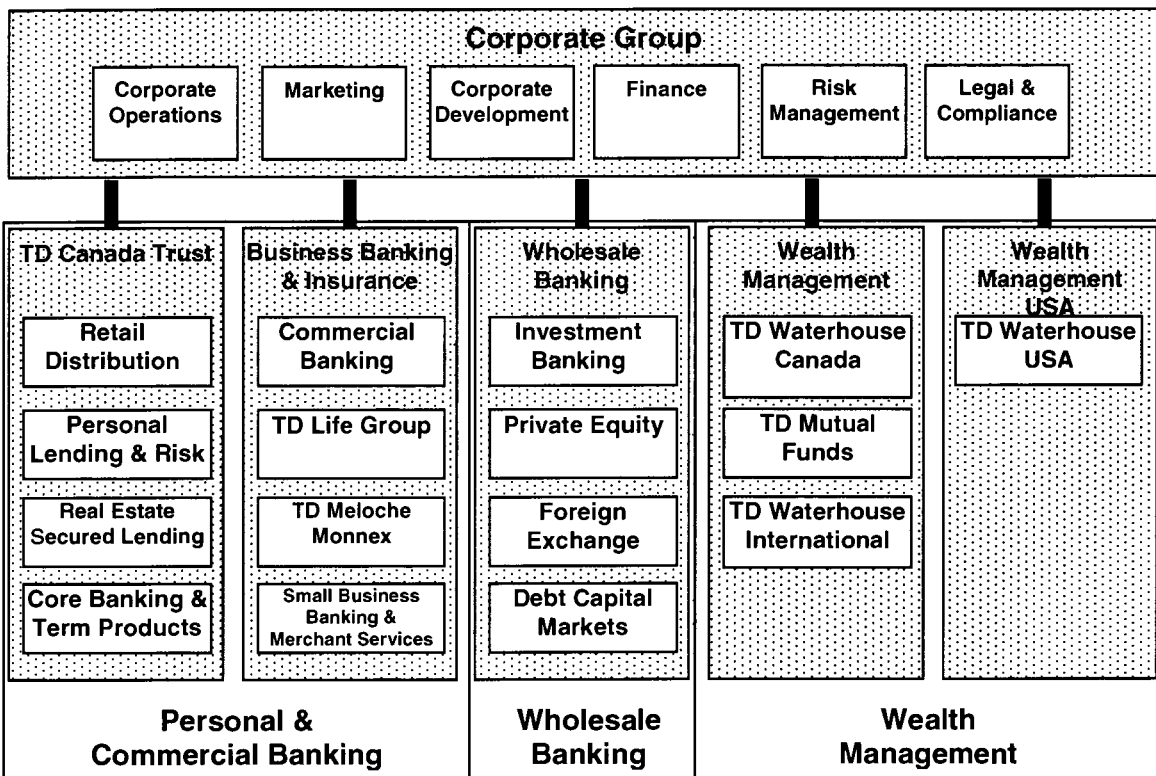
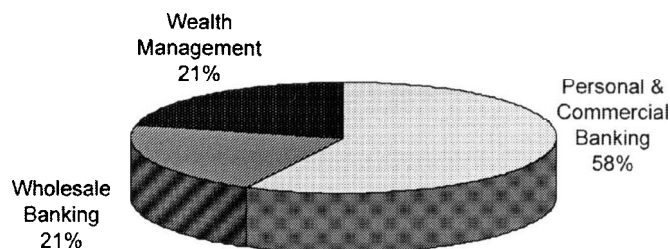


Figure 1: TD Bank Financial Group Corporate Structure

TDBFG derives the majority of its revenues from its Personal and Commercial Business. As seen in Figure 2, this business unit generated 58 percent of revenues in 2003 and it is considered to be TDBFG's core business.



**Figure 2: TDBFG Revenue by Business<sup>2</sup>**

TDBFG delivers services to the small and medium enterprise market through the Personal and Commercial Banking business. SME financing is delivered to the customer under two brands, TD Canada Trust and TD Commercial Bank. The TD Canada Trust is a brand that represents TDBFG's retail operations. TD Canada Trust distributes Personal Banking, Small Business Banking and Wealth Management products. TD Canada Trust has approximately 10 million personal, small business and insurance customers. TD Commercial Bank operates parallel to TD Canada Trust and services medium enterprises, mid-market customers and junior corporate.

As a result of the acquisition of CT Financial Services Inc. in 1999, the retail banking operations of TD Bank and Canada Trust were merged. Under the brand name TD Canada Trust, the combined operation is one of Canada's premier retail banking organizations. Branch conversions to TD Canada Trust branding were successfully completed in August 2001.

### **1.1.1 The Corporate Group**

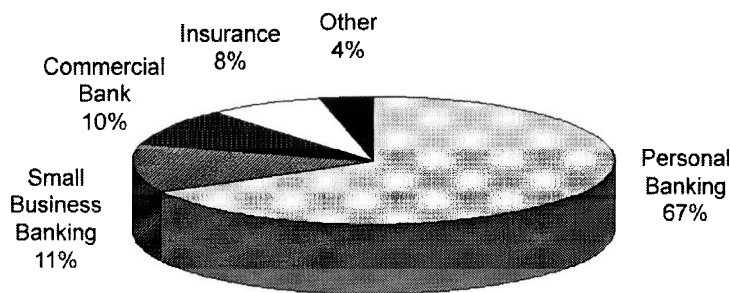
The corporate group provides support services, infrastructures and direction in areas that are common to the three bank businesses. Corporate Group's mandate is to provide centralized advice and counsel and to design, establish and implement

<sup>2</sup> Source: TD Bank Financial Group Annual Report 2003. Other revenue includes internal commissions on sales of mutual funds and other Wealth Management products, fees for foreign exchange, safety deposit box rentals and other branch services.

processes, systems and technologies to ensure that the Bank's key businesses operate efficiently, effectively and in compliance with all applicable regulations.

### 1.1.2 TD Canada Trust

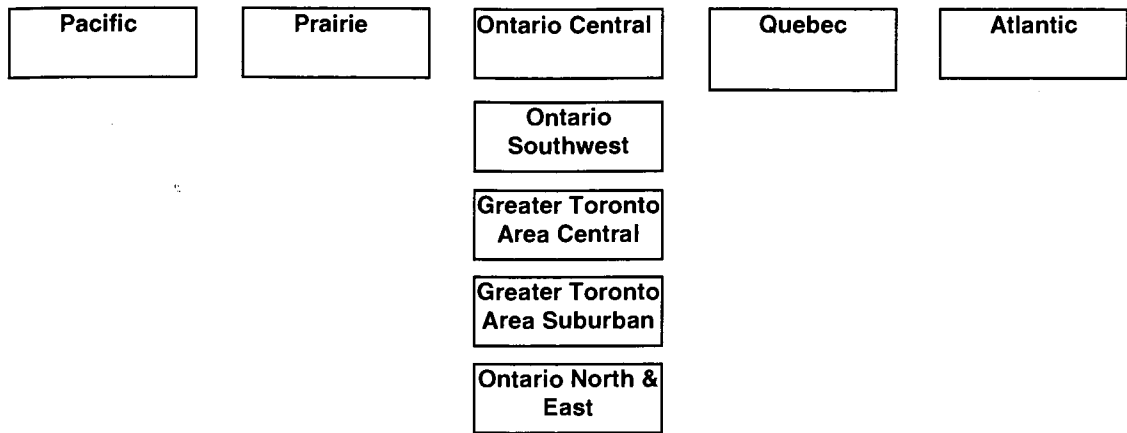
TD Canada Trust represents the Personal and Commercial Banking arm of the TDBFG. It offers banking services to customers in Canada, under the TD Canada Trust Brand, and in the U.S., under the TD Waterhouse Bank Brand. Financial services are delivered through a network of branches, the Internet, the telephone, and most recently through wireless devices such as pagers and cell phones. TD Waterhouse Bank is the largest electronic bank in the U.S. offering a full suite of personal products and services. TD Canada Trust represented 82 percent of TDBFG's income on a cash basis in 2003 and as per Figure 3, 21 percent of its revenue is derived specifically from business banking. This implies that were the Bank to meet its expectations to double its market share in SME lending, it could increase revenue by up to 20 percent.



**Figure 3: Personal and Commercial Banking Revenue by Business Unit**

#### 1.1.2.1 Retail Distribution

Retail Distribution is divided into 9 regions in order to manage the banking network across Canada's large geographic area. The majority of the Bank's branches are located in Ontario and as a result Ontario has 5 regions. As seen in Figure 4 below:



**Figure 4: 9 Regions of Retail Distribution**

Retail Distribution is supported by e. Bank, Retail Sales & Service, as well as Retail Transformation. e.Bank supports TD Canada Trust by completing billions of transactions annually and selling millions of units of products through call centres, internet banking and the ABM network. EasyWeb, the Bank's internet banking platform, has been recognized with several awards recognizing its best-in-class design and functionality and the Bank is recognized as an industry leader in web banking market penetration.

Retail Sales & Service is an integrated team dedicated to fulfilling five key functions: Sales & Service Support, Advice & Channel Support, Retail Real Estate Management, Branch Optimisation, and Retail Operational Risk. Sales & Service Support is available through a bank intranet and a call centre to assist employees throughout the retail network with product knowledge, compliance and systems use. Advice and Channel Support are a team of specialists within each region who train employees and regularly visit individual branches in each region to provide coaching. The other three focuses support the operational functions of the retail network.



### 1.1.2.2 The Regions

Each region is composed of over one hundred branches and is sub-divided into districts with up to 20 branches per district. Each region may have its own unique focuses. For example, Pacific Region has departments in several branches devoted to Asian banking, which provides banking services in Korean, Japanese, Cantonese, Mandarin, Punjabi and Hindi. The Prairie Region on the other hand has several branches with agricultural lending departments.

#### 1.1.2.2.1 The Branches

Each Branch Manager reports to a District Manager, and each branch must focus on both sales and service. The Manager Customer Service reporting to the Branch Manager, oversees the frontline Customer Service Representatives (Tellers) and Greeter (Receptionist) area. The Branch Manager directly oversees the sales staff: Small Business Advisors, (SBA) Financial Advisors (FA) and Financial Service Representatives (FSR). In larger branches this supervision is shared between the Branch Manager and a Manager Financial Services as illustrated in Figure 5. Only branches with large Small Business loan portfolios will be assigned a Small Business Advisor.

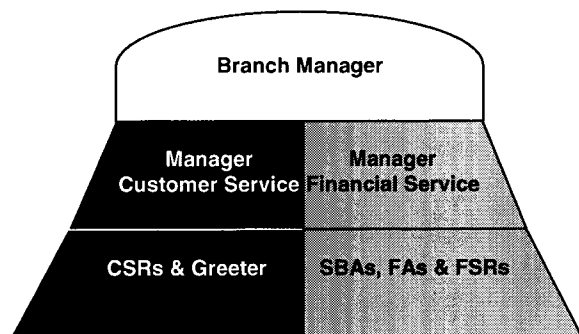


Figure 5: Branch Reporting Structure

### **1.1.3 Business Banking & Insurance**

Business Banking and Insurance are part of the TD Canada Trust and these two businesses have been singled out as key opportunities to the Bank. Because of the high potential of these businesses, the Executive Vice President (EVP) of this group reports directly to the CEO while still working closely with the President and other EVPs within TD Canada Trust.

Business and Insurance Group manages all aspects of the commercial and small businesses customer experience from product development through to credit adjudication, product support, and sales distribution. The Bank believes that by aligning the Commercial Banking, Small Business Banking and Merchant Services teams the three groups will work together seamlessly to serve business customers and become the best business bank in North America<sup>3</sup>.

The Group also manages TD Canada Trust's insurance products, which include creditor insurance, international reinsurance, and home & auto insurance.

#### **1.1.3.1 Commercial Banking**

TD Commercial Banking serves needs of businesses whose borrowing needs are too complex for the Small Business Banking product suite. Commercial banking affords more customized financing solutions and involves a greater depth of financial analysis and due diligence.

TD Commercial Bank offices are primarily found in large urban centres located in the same building as a TD Canada Trust branch. Customers of TD Commercial Bank use services provided by the retail bank such as teller services, ATMs and day to day banking. Commercial banking focuses on providing products and services to Canadian

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<sup>3</sup> Merchant Services provides card payment solutions to business customers who need to accept payment using credit cards and debit cards.

large and medium sized enterprises. The full suite of products includes lending, investing, cash management, foreign exchange, trade finance and treasury products.

Commercial banking is divided into two primary functional areas Credit Adjudication and Sales. Both functional areas are sub-divided into five regional areas with a sixth department serving the junior corporate customers who have borrowing needs in excess of \$5 million.

A loan request from a customer new to the Commercial bank would take the following path. Let us suppose that the customer first met a Manager Business Development at a Chamber of Commerce function. The Manager of Business Development would then introduce the customer to a Relationship Manager, who would then interview the customer and assess her needs. The Relationship Manager would then structure the deal with the assistance of an Analyst and together they would escalate the deal to the Manager Commercial Credit (MCC) in their office. The deal is reviewed by the MCC and she is willing to recommend it, however since it is above her limit she escalates it to Group Risk Management (GRM) at the regional level. At GRM two underwriters review the credit and authorize it. If the amount had been much larger, they would have had to escalate it to Toronto. Six employees have touched the deal since the first contact with the customer. If GRM had not approved the deal, the Relationship Manager and Analyst might have restructured it and begun the process once again.

At the branch level, the Manager Business Development and Relationship Managers report to a Manager Commercial Sales. The analysts report to the Manager Commercial Credit. The Manager Commercial Credit reports to Group Risk Management, whereas the Manager Commercial Sales reports to a District Manager.

The structure is designed to nullify a potential conflict of interest that could occur if the risk manager were to have sales targets.

### **1.1.3.2 Small Business Banking and Merchant Services**

Small Business Banking delivers products and services that are tailored to meet the banking needs of small businesses who have relatively simple banking needs that can be served in a retail branch. A common service used by our small business customers is Merchant Services. Merchant Services provides card payment solutions to customers who need to accept payment using credit and debit cards.

#### **1.1.3.2.1 Small Business Banking Product Group**

Small Business Banking Product Group is composed of three functional areas: Product & Distribution, Agriculture & Franchise Banking, and Small Business Credit. Product & Distribution is concerned with designing deposit and credit products with respect to pricing process and promotion. This group develops and executes an annual marketing plan and must engage multiple distribution channels and business units.

Agriculture and Franchise Banking develops and markets special pricing and loan guidelines for agricultural businesses and established franchise networks. The Bank recognizes that these two groups have different risk profiles than the broader market and therefore require customized solutions. The Product & Distribution unit has designed a similar pricing and loan package for Professionals, however it is less formalized than the Agriculture and Franchise packages.

Small Business Credit is composed of two credit adjudication centres. Eastern Credit Centre is located in Markham, Ontario and Western Credit Centre in Edmonton, Alberta. Small Business Advisors structure loan submissions and send them to one of the credit centres to be adjudicated. The centres are organized into teams of up to

seven Underwriters working under one Senior Underwriter. Higher limit deals and deals that are declined are all escalated to the Senior Underwriter for a second review.

#### **1.1.3.2.2 Small Business Banking Sales**

The Manager Small Business Banking Sales (MSBBS) is the individual who provides sales support to people in the branch network to assist in the sales and distribution of small business products and services. They provide product and market information to Small Business Advisors, and they train and coach Financial Advisors and Financial Service Representatives. The MSBBS reports to a Regional Manager of Small Business Banking Sales who in turn reports to the Assistant Vice President of Small Business Banking Sales in Toronto. It is significant to note that SBA's do not report to any part of the Small Business Banking Sales group.

#### **1.1.4 Wholesale Banking**

Wholesale Banking, distributed under the TD Securities brand offers a variety of capital market products and services to corporate, government and institutional customers in five key finance areas.

Through its Investment Banking division, TD Securities provides services and advice to clients to assist them in mergers and acquisitions, divestitures, capital structuring and risk management. Investment Banking also provides services in the placement of common equity, preferred shares, private equity, debt securities, debt syndications and bridge financing.

TD Securities' Debt Capital Markets division provides its global client base with origination, trading and sales of money market, investment and non-investment grade fixed income instruments as well as derivatives.

The Institutional Equities division, under the TD Newcrest brand, provides equity sales, trading, research, underwriting and distribution in North America.

The Private Equity division, under the TD Capital brand, provides equity and mezzanine financing to middle-market customers in order to finance management buyouts, expansion, acquisitions, industry consolidations and recapitalizations.

Finally, the Foreign Exchange division provides foreign exchange spots, forwards and options.

### **1.1.5 Wealth Management**

Wealth Management provides a wide array of investment products and services, the majority of which are provided through three key businesses: TD Mutual Funds, TD Private Client Group and TD Waterhouse Canada.

#### **1.1.5.1 TD Mutual Funds**

TD Mutual Funds offers more than 70 mutual funds and 30 managed portfolios. These funds are distributed through the retail branch network, TD Waterhouse's discount and full brokerage as well as in house financial planners. The funds are also distributed through external brokers and financial planners.

#### **1.1.5.2 TD Private Client Group**

TD Private Client Group provides discretionary account management to clients with large investment portfolios. This group also provides estates and trust services as well as insurance products for wealth protection. The Private Banking Group is also division of TD Private Client Group.

#### **1.1.5.3 TD Waterhouse Canada**

TD Waterhouse Canada offers brokerage services and no-fee financial planning. Customers can choose from discount brokerage or full brokerage services. Discount

brokerage provides low cost access to stock market trading for customers who want to make their own investment decisions without the benefit of a broker's advice. Trading is accessible by phone or the Internet and market information is provided via the website and direct mail. Full brokerage, called TD Waterhouse Investment Advice provides trading services and advice along with active account management. TD Waterhouse Financial Planning accounts do not allow trading in stocks, however they do provide no fee full financial planning and the ability to invest in mutual funds, money market and fixed income instruments.

### **1.1.6 TD Waterhouse USA**

TD Waterhouse USA provides discount brokerage services to customers in the United States. TD Waterhouse USA has over 2.1 million customers and over \$108 billion in customer assets.

## **1.2 Focus of this Strategic Analysis**

TD Canada Trust presently has a three-pronged strategy. The primary initiative involves preserving and improving on the Bank's core competency in expense management and efficiency. The second initiative is the Bank's commitment to deliver superior service and a premium brand based customer experience. This premium brand will be leveraged to extract lifetime value of the customer by improving customer retention, customer attraction and cross selling to current customers. The last piece of the Bank's strategy is to focus on growth of under penetrated businesses that have the potential for above average growth rates. These "super growth" business units are commercial banking, small business banking and insurance.

This paper will assess the current environment in which the Bank operates and identify key success factors in the SME financing business. It will then examine TDBFG's current internal capabilities, and recommend whether TDBFG should

undertake an optimal strategy or an alternative strategy given its current capabilities.

Presently the SME customer category is served by both the small business banking arm of the TD Canada Trust and the TD Commercial Bank and as a result any recommended solutions will focus on these two business units.



## **2 CHAPTER TWO: THE SME LENDING INDUSTRY**

### **2.1 Business Lending Defined**

The small and medium sized enterprises (SME) market segment typically consists of organizations with fewer than 500 employees, \$50 million in revenues and are owner operated. The Canadian Bankers Association defines small enterprises as those businesses with authorised borrowing levels under \$500,000 and medium enterprises as those with levels under \$1,000,000. SMEs are critical to the Canadian economy, make up 43 percent of Canada's GDP, and are the primary engine for job creation.<sup>4</sup> While SMEs are good for the Canadian economy, they are also a great opportunity for financial institutions in Canada. In 2001, authorized debt financing to SMEs reached almost \$149 billion of which only 49 percent was supplied by the 14 domestic banks.<sup>5</sup> The other 51 percent is supplied from non-bank sources.<sup>6</sup>

### **2.2 Industry Analysis**

Canada is a small player on the world financial stage, which is not surprising given its relative GDP and population. It represents only 2.4 percent of the world's equity market capitalization, down from 3.8 percent in 1982 and had only a 2.9 percent share of global personal financial services and insurance profits in 1998.<sup>7</sup> As seen in Table 1, ranked by assets, not one of Canada's banks rank in the top 50 globally.

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<sup>4</sup> Canada. Industry Canada. *Key Small Business Statistics*. Ottawa, April 2004: 22

<sup>5</sup> Canada. Statistics Canada. *Survey of Suppliers of Business Financing 2002*

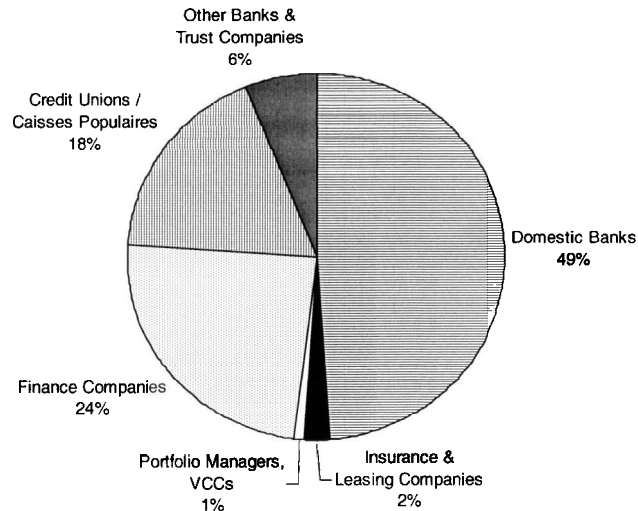
<sup>6</sup> See Figure 6 below.

<sup>7</sup> McKinsey & Company, *The Changing Landscape for Canadian Financial Services: New forces, new competitors, new choices*, Ottawa: Department of Finance, September 1998: 11

Rank	Bank	Bank Country	Assets (\$ millions CDN)
1	Citigroup	U.S.	\$1,730,927
2	Mizuho Financial Group	Japan	\$1,705,013
3	UBS	Switzerland	\$1,343,620
4	Sumitomo Mitsui Financial Group	Japan	\$1,332,700
5	Deutsche Bank	Germany	\$1,254,594
51	Royal Bank of Canada	Canada	\$ 372,995
60	Scotiabank	Canada	\$ 291,174
64	The Toronto-Dominion Bank	Canada	\$ 273,318
65	Canadian Imperial Bank of Commerce	Canada	\$ 269,399
66	Bank of Montreal	Canada	\$ 248,690

**Table 1: Global Bank Rankings by Assets<sup>8</sup>**

In Canada's SME financing market it appears that banks are the preferred supplier of financing. However, even though the major banks dominate the market with 49 percent market share, as seen in Figure 6, there are many other players in this market. The SME financing market size is approximately \$146 billion.<sup>9</sup>



**Figure 6: Total Credit Authorizations for Firms with Authorizations under \$1 million<sup>10</sup>**

<sup>8</sup> Source: The Banker, July 2003

<sup>9</sup> Canadian Bankers Association. *Competition in the Canadian Small and Medium-sized Business Financing Market*. Dec. 2000: 2

<sup>10</sup> Canadian Bankers Association, *Competition 3*

A five forces analysis of the SME financing market reveals a very competitive marketplace.<sup>11</sup> As seen in Figure 7, low barriers to entry, high supplier and buyer power, a high threat of substitutes and high competitive rivalry, characterize the market.

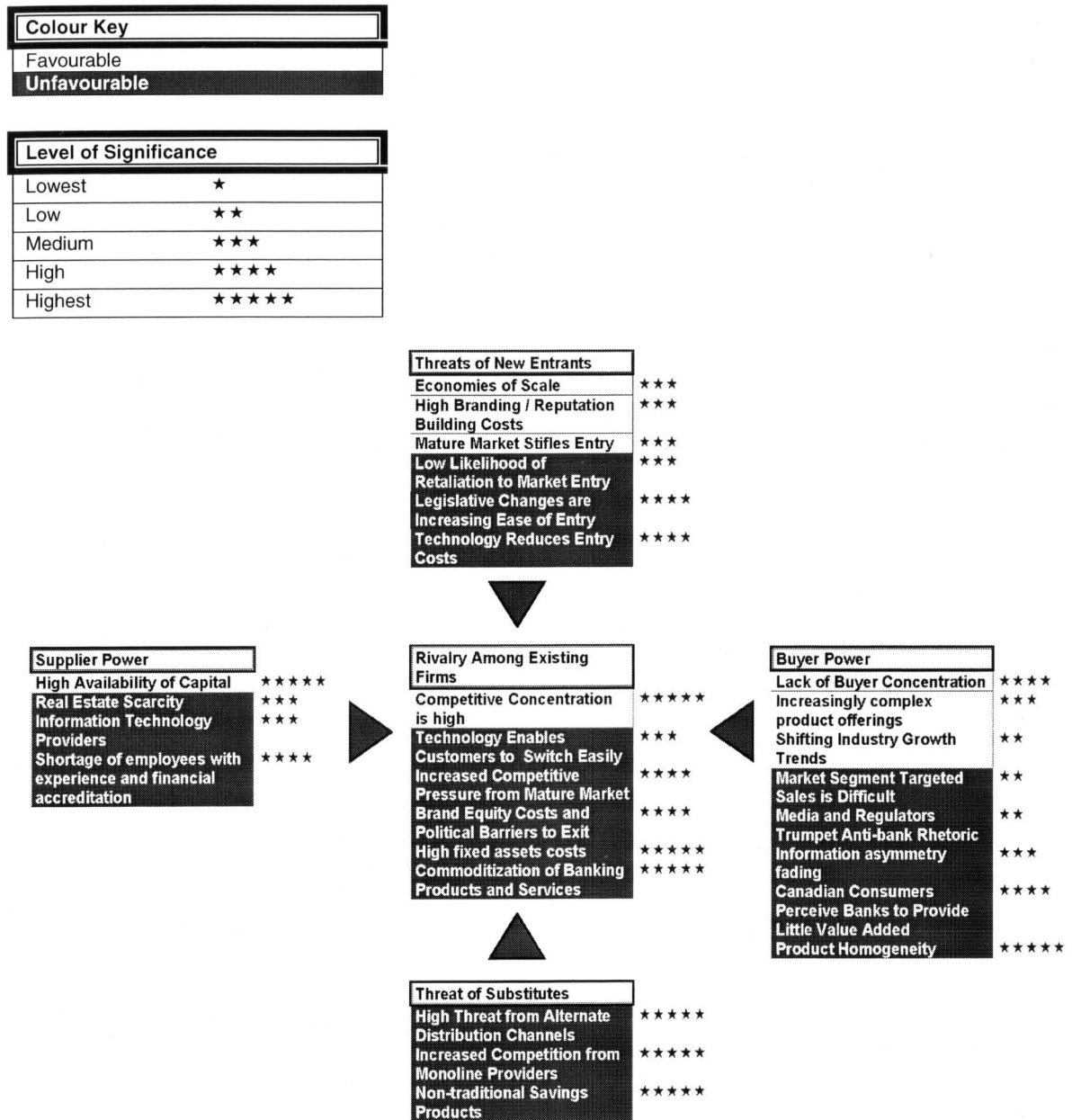


Figure 7: Competitive Analysis Chart of SME Lending in Canada

<sup>11</sup> Adapted from Porter, Michael E. *Competitive Strategy: Techniques for Analyzing Industries and Competitors*. New York: The Free Press, 1980: 4

## **2.2.1 New Entrants**

### **2.2.1.1 Legislative Changes are Increasing Ease of Entry**

Before 2001, under the Bank Act no shareholder of a large bank could hold more than 10 percent ownership. With the changes in brought about in Bill C-8, one shareholder is now able to own up to 100 percent of a small bank and up to 20 percent of a medium to large bank. This was expected to encourage the creation of more banks.

Telecommunications companies, grocery retailers, businesses with existing retail networks or strong online presence that can be used to distribute banking services would most likely launch these banks. Another legislative change, which increases ease of entry, is the reduction in capital requirements needed to apply for a bank licence from \$10 million to \$5 million. As of year-end 2003 there has not been significant new entry although there are some interested parties.

Although legislation is facilitating entry, the federal government still retains control of who can establish a new bank. In order to preserve a safe and stable financial system, applicants must demonstrate the financial wherewithal, and management ability to successfully operate a bank in Canada. The federal government must also approve shareholders wishing to acquire 20 percent of a large bank.

Legislation now allows foreign banks to directly operate in Canada using a branch network, rather than requiring them to set up a separately capitalized subsidiary. This increases the capital availability of foreign banks operating in Canada since they will be able to draw on the capital of the foreign parent company.

Prior to the passage of this legislation only deposit taking institutions could access the payments system. This meant that other financial institutions could not access the cheque clearing system, credit card systems or the Interac network. Under new law non-deposit taking institutions, such as insurance companies, securities dealers

and mutual fund companies have access to these networks and can offer their customers banking services.

### **2.2.1.2 Technology Reduces Entry Costs**

The Internet has had a tremendous impact on banking. Although incumbent bricks and mortar banks have made unsuccessful attempts at launching online subsidiaries, ING Group has successfully proven the online banking business model.<sup>12</sup> ING Direct was first launched in Canada in 1997 and presently has over 850,000 Canadian clients, and over \$12 billion in assets. It has since used this winning business strategy to enter 6 additional countries in Europe, North America and Australia. It is possible for ING or another company to enter the SME financing market in the same fashion.

Wells Fargo, a very successful SME lender from the United States, which entered the Canadian SME loan market in 1999 using an electronic platform and a direct mail marketing campaign met with limited success and subsequently exited the market.

The online banking business model reduces capital costs associated with a physical branch distribution network. This strategy is also easily reproduced however online banks are limited to providing services that do not require a branch network.

HSBC, entered the market by purchasing the Bank of British Columbia in 1986. HSBC however entered the market as a full service bank with both personal and business product lines. HSBC also invested heavily in the business banking division and presently, among domestic banks, it has a 12.5 percent share of the SME market up from 3.4 percent in 1999.

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<sup>12</sup> ING Group, Press Release, Amsterdam, 20 October 1999

### **2.2.1.3 Low Likelihood of Retaliation to Market Entry**

Given the close regulatory oversight of the Canadian banking system, it is unlikely Canadian banks would engage in retaliatory practices in the event of new entry to the market. In addition, since Canadian banks are perceived to wield excessive clout domestically, if they were to engage in predatory behaviour, public opinion would quickly turn against the incumbents and the Canadian government would likely intervene.

### **2.2.1.4 Economies of Scale**

Banking is a low margin business, and as a result there are significant economies of scale to be gained for small and medium sized banks. Some of these economies of scale can only be realized through size, however many can be gained through outsourcing back office and administrative functions. There are few, if any, economies of scale to large banks becoming even larger. Studies show that size does not correlate with cost reduction, but that banks find greater efficiencies when faced with high competition as a result of deregulation.<sup>13</sup>

Credit Unions, typically smaller players in SME financing have invested significantly in back office centralization over the past 10 years in order to realize economies of scale.

### **2.2.1.5 High Branding / Reputation Building Costs**

Consumers entrust their savings, personal information, and their consumption information to financial institutions. As a result, banks invest heavily in promoting an image of trustworthiness and stability. Banks invest heavily in brand building through advertising, branch design and community sponsorship.

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<sup>13</sup> Carbo Valverde, S., Humphrey, David B., and Rodriguez Fernandez, F. Bank deregulation is better than mergers. *International Financial Markets, Institutions and Money*. (2003). Vol.13: 431

### **2.2.1.6 Mature Market Stifles Entry**

The SME financing market is a mature market with an expected growth rate between 5 percent and 7 percent.<sup>14</sup> Any new entrant would have to gain market share at the expense of incumbents. The aggressive pricing and advertising necessary to entice customers to switch erodes margins.

### **2.2.1.7 Low Barriers to Entry**

Although, economies of scale and high reputation building costs present significant barriers to entry into the Canadian SME financing industry, there are many foreign banks and large finance companies with the similar products and brand equity who are not yet operating in the market. Companies such as ING Direct or GMAC could use the economies of scale afforded by their personal lending businesses and their recognized brand to enter the market. Witness HSBC's entry into the market in 1986 and its growth to 12 percent market share.

As well, the incumbents in the industry are under heavy government scrutiny, so their ability to retaliate against a new entrant is very limited. The government is intent on increasing competition in this industry and is reducing legislative and regulatory barriers to entry. Finally, technology is allowing banking distribution to take place with lower overhead costs and without having to employ bricks and mortar distribution, which increases the potential scale of entry while reducing the capital outlay.

The Canadian SME financing market can expect more attempts to enter the market. Given the success of HSBC and the lessons learned by Wells Fargo's failed entry, in the medium term there is a high likelihood of new entrants.

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<sup>14</sup> Canada. Statistics Canada. *Survey*.

## **2.2.2 Suppliers**

### **2.2.2.1 Shortage of employees with experience and training**

Training for a new commercial financial analyst can take up to a year. Banks pay for their employee training courses and on the job training is a significant cost. This reliance on in house training and the lack of outside accreditations in the business-lending field has increased the power of trained and experienced employees.

There are frequent instances where employees are poached from one financial institution to another. This is an attempt to shift the risk of investing in employee training from the acquiring institution to the one losing the employee; as well it is an attempt to avoid the cost of training employees. Generally these employees are offered a 10 percent increase in pay to leave their current employer, which leads to an upward trend in labour costs.

### **2.2.2.2 Information Technology Providers**

Increasingly, banks are relying on third party suppliers for services such as digital document storage, computer networks, telephone systems, transaction processing, merchant services, credit scoring and ERP systems. These are fundamental business functions and as a result the risks of the service providers can potentially impact the risk to a bank. In most cases, these functions have been outsourced to take advantage of economies of scale or to large investments in developing business functions, which are not core competencies. As a result of these needs for economies of scale and the scale of business transacted with a particular supplier, there are usually very few suppliers in the market. The scarcity of alternative suppliers as well as the high switching costs for these services, gives suppliers a degree of power over banks. The largest 5 Canadian banks have resolved this, in some instance, by securing ownership in many of their



service suppliers, however smaller banks and credit unions have to find other solutions to mitigate supplier power.

#### **2.2.2.3 Real Estate Scarcity**

Most Canadian banks and credit unions rely on a retail branch distribution network. Suitable real estate for branches is scarce, as the incumbents have already established branches in the most suitable locations. As well, since banks require unique leasehold improvements to accommodate large safes and sophisticated security systems, landlords have the ability to extract long-term commitments and higher rents.

Finance companies often distribute their loan and lease financing through the equipment vendors and vehicle dealerships. The finance companies are often affiliated with the dealers. This reduces the cost of distribution, however since they do not have direct contact with their customer the risks are greater.

#### **2.2.2.4 High Availability of Capital**

Large Canadian banks, insurance companies, and finance companies have high capital availability both through equity markets, bond issues and securitization of assets such as their mortgage and consumer credit portfolios. Smaller banks, due to poorer credit ratings have slightly higher cost of funds. This can have a significant impact on ROA since banking is a low margin business. Market forces do not set Credit Union cost of funds. Members own shares of the credit union and receive a dividend at the discretion of the Board of Directors. Except of Credit Unions, large banks benefit from lower cost of funds and capital availability.

#### **2.2.2.5 High Supplier Power**

Suppliers to the Canadian banking industry, including SME lenders, have high relative clout. Many have products and skills that are needed in the banking industry but are transferable to other industries as well. Granted, the incumbents in the SME

financing market have high capital availability. The largest players are major Canadian banks with billions of dollars in market capitalization and relative ease when raising capital either in debt or equity markets.

This clout however is tempered by relative real estate scarcity. Banks depend on branch distribution as their primary method of contact with customers, and the number of suitable locations is limited. There are very few untapped markets and as a result when a location does become available the landlords have greater leverage.

As well, once a bank has committed to certain IT and IS providers, the relationship is necessarily long term. The banks may have clout during the bidding process, however once a bank is running on a platform and the employees have been trained to the platform the bank is dependent on that supplier.

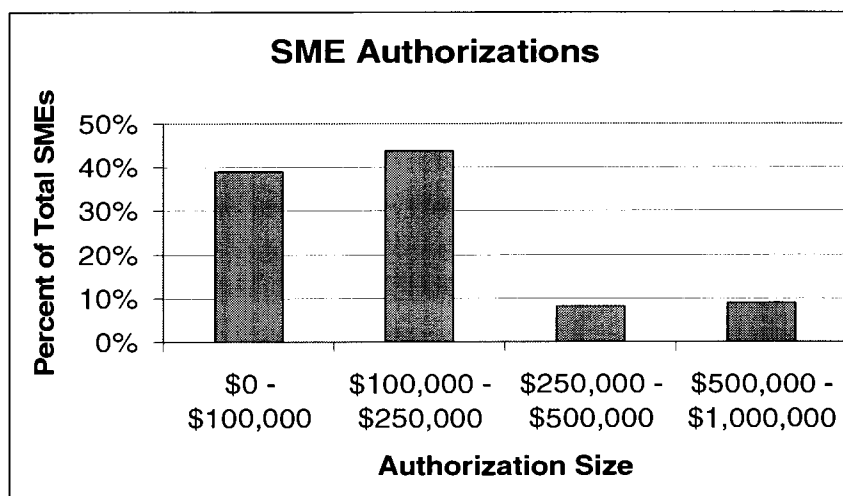
Finally, a shortage of accredited, trained and experienced employees constantly challenges the industry. Banks attempt to reduce turnover by providing high benefits, profit sharing and stock purchase plans however turnover continues to be a challenge.

### **2.2.3 Customers Analysis**

Relative to their lenders, SME borrowers are very small and diffused. There are some associations of SMEs, such as the Canadian Chamber of Commerce and the Retail Merchants Association, which have negotiated group pricing for merchant services and insurance, however due to the risk characteristics unique to each SME borrower these Associations have not negotiated group pricing for financing. The only category that has negotiated group pricing for financing is franchises. Since franchisees will each have similar risk profiles to one another and the group has a lower risk than unbranded business, banks have been able to create uniform pricing packages for franchises.

Traditionally, banks have segmented the SME market based on the amount of authorized credit. Based on this criterion, there are three market segments in the SME market. There are small enterprises with authorized credit under \$500 thousand and medium sized enterprises with authorized credit under \$1 million. Micro businesses are another segment usually with financing under the \$25 to \$99 thousand range, however there is little consensus on the definition of this segment. Micro businesses are also described as self-employed businesses or home-based businesses. Micro businesses<sup>15</sup> comprise 39 percent of SMEs who borrow from domestic banks; Small enterprises<sup>16</sup> comprise 52 percent while medium-sized enterprises make up the remaining 9 percent of the market.

As per Figure 8, eighty-three percent of bank borrowers have credit authorizations under \$250,000<sup>17</sup>, however 52 percent of funds authorized by domestic banks are authorized for borrowers with limits over \$250,000.



**Figure 8: Authorization Sizes of SMEs Borrowing from Domestic Banks<sup>18</sup>**

<sup>15</sup> Borrowers with credit authorizations less than \$100,000.

<sup>16</sup> Borrowers with credit authorizations of \$100,000 - \$500,000.

<sup>17</sup> Canada. Statistics Canada, *Survey*.

<sup>18</sup> TD Bank Financial Group proprietary

Different regions of Canada have different industry focuses. As seen in Table 2, the prairies have a strong agricultural sector. Quebec, Ontario, Alberta and BC all have significant professional communities. Likewise they have the greatest concentrations of knowledge-based industries.

	Agriculture	Primary	Manufacturing	Wholesale / Retail	Professional	Knowledge Based	Other Sectors
<b>Atlantic Provinces</b>	6.6%	9.4%	5.1%	15.0%	7.5%	2.3%	54.2%
<b>Quebec</b>	9.7%	1.7%	7.1%	13.2%	10.8%	4.0%	53.4%
<b>Ontario</b>	8.5%	0.7%	5.6%	10.4%	12.5%	5.6%	56.7%
<b>Man/Sask/Nunavut</b>	44.8%	1.2%	3.0%	8.2%	4.3%	1.9%	36.7%
<b>Alberta/NWT</b>	20.2%	3.8%	3.5%	6.8%	12.3%	5.1%	48.3%
<b>BC/Yukon</b>	3.9%	3.2%	5.5%	10.2%	12.7%	4.2%	60.4%
<b>Canada</b>	<b>12.9%</b>	<b>2.2%</b>	<b>5.4%</b>	<b>10.4%</b>	<b>11.1%</b>	<b>4.5%</b>	<b>53.4%</b>

**Table 2: SMEs' Sectors of Operations by Region in 2000<sup>19</sup>**

An Angus Reid survey of SMEs in 2000 found four perceived gaps in financing services.<sup>20</sup> These gaps are size, risk, knowledge, and flexibility. SMEs often feel that their financing requests are too small to gain the attention of banks and that banks are more interested in larger volume deals. SMEs also believe that Canadian banks have a very limited appetite for unsecured lending and are not willing to assume any risk. SMEs in knowledge based feel that financial institutions do not understand their businesses and that they are too quick to discount knowledge assets, such as patents, software and the goodwill associated with an established brand. Finally, SMEs feel frustrated with the lack of flexibility in what they believe is a “cookie cutter” approach to financing, where standard ratios and credit scoring methods take precedence over common sense business decisions. As much as possible, TDBFG’s optimal strategy will attempt to address these financing gaps.

<sup>19</sup> Canada. Industry Canada, *Small and Medium-sized Enterprise (SME) Financing in Canada*, Ottawa, 2002: 61

<sup>20</sup> Angus Reid Group, *Financing Services to Canadian Small and Medium Size Enterprises*, July 2000: 19

### **2.2.3.1 Information asymmetry fading**

Regulators are working in conjunction with institutions to ensure consumers are adequately informed and protected by establishing disclosure rules and guidelines.<sup>21</sup>

Transparency of information is critical given the history of information asymmetry between consumers and institutions. Although many bank products are very similar, they are presently presented in a way that makes inter bank comparisons difficult. For example, a year ago the top five banks described interest rates on unsecured lines of credit differently. Some tied the variable rate to the Prime rate and others tied it to their Base rate. The Base rate is proprietary and not set by the market, and although it is related to the Prime rate, different banks set their own Base rates. As a result of government intervention, this practice has ended, however there are similar difficulties when attempting to compare service charges at different institutions. As a result of government regulated greater disclosure, customers are more informed and sophisticated.

As demographics change, the average Canadian is becoming older and better educated. As a result, they are becoming more knowledgeable and sophisticated in evaluating their financial service providers. They are also becoming more comfortable with alternatives distribution channels and service providers.<sup>22</sup>

### **2.2.3.2 Product Homogeneity**

Banking products are fairly homogeneous. This limited differentiation allows customers to more easily compare between providers and reduced differentiation limits banks' ability to charge higher margins.

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<sup>21</sup> The Financial Consumer Agency of Canada (FCAC) was founded in 2001 under the Financial Consumer Agency of Canada Act to consolidate and strengthen oversight of consumer protection measures in the federally regulated financial sector, and to expand consumer education.

<sup>22</sup> McKinsey & Company, *The Changing Landscape* 25

### **2.2.3.3 Canadian Consumers Perceive Banks to Provide Little Value Added<sup>23</sup>**

The vast majority of Canadians are satisfied with the service provided by their banks, however the number of dissatisfied customers is growing. Compared to other service providers, when consumers were asked if the services provided were very good or excellent, Canadian banks ranked lower than supermarkets and air travel but higher than department stores and auto dealerships. If the satisfaction trends continue, consumers will become increasingly open to alternative banking service providers.

### **2.2.3.4 Media and Regulators Trumpet Anti-Bank Rhetoric**

Canadian media and regulators have increasingly echoed the rhetoric of special interest consumer groups such as the Democracy Watch, Consumers' Association of Canada and the People's Network on Banking, Credit and Capital. These groups focus on the size and power of banks in the Canadian Competitive Analysis Chart of SME Lending in Canadian economy and push for greater control and regulation of banks. These groups also advocate nationalizing other industries to protect consumers from profit seeking corporations. This type of media attention restricts banks to conservative marketing and sales practices, which in turn reduce differentiation and increase competition.

### **2.2.3.5 Increasingly Complex Underwriting Processes**

With greater software sophistication and credit scoring systems, customers often do not understand why they were approved, declined or why they must meet ongoing financial conditions for leverage and cash flow. An Account Manager at a major Canadian bank sells from a suite of over 20 debt product products and services in addition to a multitude of deposit and cash management products. When customers are presented with a huge product offering with varied bundled and un-bundled pricing structures, they are more likely to purchase based on the advice of a bank employee,

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<sup>23</sup> McKinsey & Company, *The Changing Landscape* 67

rather than attempt to learn the product offering well enough to make their own informed decision. This and the fact that consumers of bank services are not very price sensitive gives banks some leverage in the producer-consumer relationship.

#### **2.2.3.6 Lack of Buyer Concentration**

Except merchant service agreements negotiated by trade associations and group pricing for franchises, consumers of Canadian financial services do not form buying groups to negotiate products and pricing with banks. There is a concentrated group of financial service providers, each negotiating with individual SMEs on a one to one basis. This again gives banks a distinct advantage in preserving fees and interest rate spreads.

#### **2.2.3.7 Buyer Power is Low**

Although public information on SME lending is improving, it is still not high. The SME lending products are fairly homogeneous, however buyer concentration is very low and customers are not aware of the high level of homogeneity. Customer price sensitivity is low and on the whole customer power is low.

Even though buyer power is low, customer retention is still a real issue. Typically it costs five times more sell to a new customer than cross sell that same product to an existing customer.<sup>24</sup> As a result of this TD Canada Trust has chosen to differentiate itself by providing the most comfortable banking experience. This does not necessarily contradict its low cost provider strategy, it is directed more toward the customer experience and corporate culture. This strategy is similar to those of Walmart and Westjet, which are both low cost producers but have nurtured customer centric cultures that result in higher repeat business than their competitors. TD Canada Trust has been recognized as an industry leader with one of the best managed brands in the financial

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<sup>24</sup> Deloitte. *Global Banking Industry Outlook: 2004 Top Ten Issues*.

services industry, preserving Canada Trust's reputation for strong customer service.<sup>25</sup>

Chris Armstrong, Chief Marketing Officer at TDBFG won Marketing's Marketer of the Year for 2001.

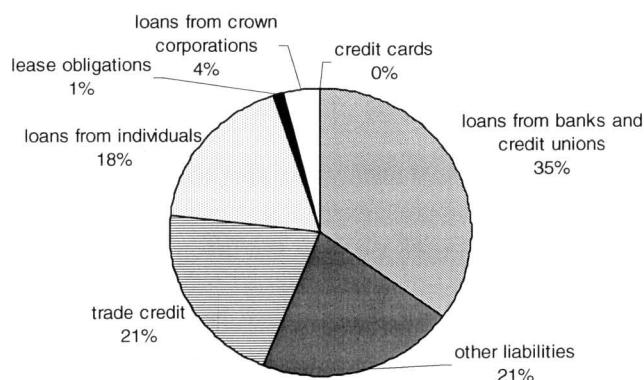
### 2.2.4 Substitutes

SMEs find financing for their businesses from a variety of sources. Even though, there are six banks that dominate the business loan market, there are other products to consider. While Table 3 provides a broad perspective on the types of financing and shows that individual SMEs source their financing needs from a variety of sources, it does not provide an accurate picture of their share of SME liabilities.

Financing Instrument	Percent of SMEs that use that Instrument
Loans from Financial Institutions	49%
Supplier Credit	39%
Personal Savings	35%
Personal Credit Cards	33%
Retained Earnings	31%
Business Credit Cards	26%
Leasing	16%
Personal Loans	14%
Loans from friends and relatives	10%
Government lending agencies	7%
Angel investment	4%

**Table 3: Sources of SME Financing<sup>26</sup>**

Figure 9 shows the share of SME financing undertaken by each source.



**Figure 9: Breakdown of SME Liabilities by Type, 2000<sup>27</sup>**

<sup>25</sup> Woolstencroft, Timothy and Hanna, Jeannette. "The Best-managed Brands are about Delivering Customer Experience" *Marketing*. 21 June 2004: 33.

<sup>26</sup> Canadian Bankers Association, *Competition 6*



### 2.2.4.1 High Threat from Alternate Distribution Channel

Canadian Domestic Banks are under increasing pressure from service providers using alternative distributions channels. In 2001 CIBC created Amicus a division responsible for operating non-CIBC branded electronic banking services. In the US, Amicus offered personal banking in Safeways under the Safeway SELECT brand. In Canada, Amicus operates President's Choice Financial out of Loblaws and it used to offer business banking under bizSmart branding in Business Depot stores. There are challenges related to chequing account and business current account services online and in November 2002 CIBC began to wind up Safeway SELECT and other US electronic Banking relationships, as these operations were not meeting financial expectations. President's Choice Financial was expected to break even in 2003, however CIBC's reporting for electronic bank operations is now combined with the branch retail operations and figures for this division are no longer available. ING Direct and Citizens Bank have both successfully entered the market using electronic distribution by providing a simple suite of banking services and avoiding highly transactional, fee based, chequing accounts. Wells Fargo made a failed attempt to enter the market in 1999. The company has not provided much insight into why it exited the Canadian market, however its pricing was not lower than the competition.

Mortgage Brokers also compete against traditional branch distribution, sometimes obtaining greater rate discounts from Canadian Banks than their branch networks are able to offer. Similar agency issues exist in equipment financing, where banks have begun to offer car and truck loans through dealerships, in order to compete against the incumbent finance companies, and these same loans are not offered through the retail branches.

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<sup>27</sup> Canadian Bankers Association, *Competition 6*

### 2.2.4.2 Increased Competition from Monoline Providers

An increasing variety of single product businesses compete against Canadian retail banks. In credit cards, MBNA, CapitalOne, Citibank and American Express are well established both in Canada and internationally. Other examples of niche players in credit are, GMAC in car financing and the Business Development Bank, a Crown Corporation. Factoring companies also fall under this category even though they have found limited acceptance in the Canadian market.

In 1997 ING Direct began offering non-traditional savings accounts. American Express followed ING in 1999 offering a similar savings account product with high interest rates, no fees and no minimum balance requirements.

## 2.3 Value Chain Analysis

The banking industry has a palindromic value chain with customers at both ends. The deposit sold to one customer is pooled with other deposits and then re-packaged as a loan product sold to another customer. In effect, a bank is an exchange broker earning a commission spread between loan and deposit rates. We are limiting the scope of this value chain analysis to the business lending product category, which, as represented in Figure 10, is linear.

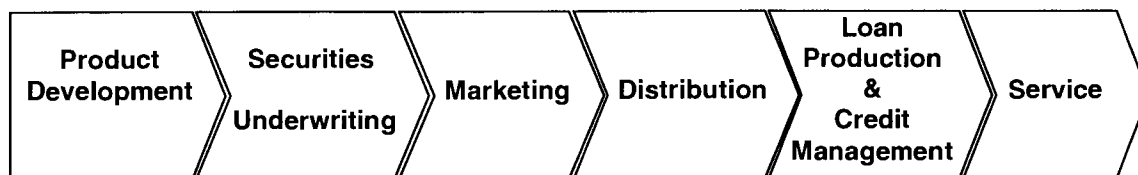


Figure 10: SME Lending Value Chain

### 2.3.1.1 Product Development

Product development involves the creation and research of new financial products and instruments. This group will design products and evaluate their potential

performance and profitability. This group delineates product definitions, term and conditions and evaluates the opportunities for bundling and the appropriate pricing limits. If Product Development determines that the Bank cannot profitably produce a product and they determine that the Bank needs to offer the product, they will refer the need to outsource management. The business product group has made very limited use of outsourcing.

When designing a product, product group must design with the entire product life cycle in mind.<sup>28</sup> Using market research, Product Design at TDBFG looks for innovative ways to redesign traditional banking products to make them more attractive to customers. An example of this is the “cash back mortgage”. A cash back mortgage is booked at the market rate however the customer receives a percentage of the borrowed amount as cash back on the mortgage. Another product is the “below prime mortgage” which offer a rate below prime rate for the first 6 months and then reverts to regular market rates. In both these instances the benefit to the customer is equivalent to less than a 0.75 percent discount on the standard mortgage rates. These innovative products allow the Bank to gain market share without competing on price, effectively preserving bank margins. They also create a degree of differentiation for what would otherwise be a commoditized product offering.

### **2.3.2 Securities Underwriting**

Securities and risk management is the process by which bank assets are classified by risk and matched with a bank liability of corresponding duration. As well, instead of matching funds from deposits to loans, the Bank may securitize a loan portfolio and sell it on the secondary market. Securitizing creates a pass through, such as a mortgage-backed security, by which the pooled assets become standard securities

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<sup>28</sup> See Appendix A

backed by those assets and is exchanged for cash. The cash in turn increases the Bank's liquidity and ability to extend more loans.

### **2.3.2.1 Securitization Design at TDBFG**

Securitization is used to preserve the Bank's liquidity. For example, a portfolio of similar risk mortgages is pooled and sold as an income product with similar characteristics to a bond. When the instrument is sold, the Bank receives cash in return for the sale of the assets. The Bank is then able to lend this cash to additional borrowers. Securitization increases the efficiency of a key component of the multiplier effect. Loans can be packaged as mortgage backed securities, banker's acceptances and bonds, issued by the Bank.

### **2.3.3 Marketing**

Marketing is responsible for market research, brand management, advertising, and sales. Sales may involve sales support for a retail or branch network, or it may involve direct sales via Internet or direct mail. Marketing will also support product sales and development for broker and agent channels.

#### **2.3.3.1 Marketing Analytics**

The Bank regularly reviews its customer base to look for higher margin opportunities. Recently marketing analysis has identified commercial and small business banking, and insurance as high margin growth opportunities for the Bank. Marketing also researches competing products in North America and around the world to prepare the Bank for any potential threats.

#### **2.3.3.2 Market Research**

The Bank contracts out market research hiring a marketing agency, Harrod & Mirlin/FCB, to conduct surveys and customer focus groups. The Bank also conducts data mining to support its telemarketing and direct mail efforts.

### **2.3.3.3 Advertising**

The Bank's advertising is split amongst newspaper, radio, magazine, online and interior transit advertising. Print ads also run in newspapers across the country, including the Globe and Mail, Toronto Star and National Post, as well as in national consumer and business magazines. The primary purpose of advertising is to communicate the Bank's value proposition and positioning as the most comfortable bank to deal with.

### **2.3.4 Distribution**

Distribution represents the contact point with the consumer. In the banking industry products may be offered through a wide variety of distribution channels.

#### **2.3.4.1 Bank Branch**

The majority of Canadian banking services are sold through bank branches. These are fixed retail locations owned by chartered banks, trust or credit unions. These retail operations carry a full suite of business lending products.

At TDBFG the retail branch network is considered the most stable source of cash flow for the Bank. The branch network's primary function is sales of products and services. The Bank has recently focused the attention of the branch networks on the higher valued customers. The cost of the branch network is very high, and to the network to run efficiently employees must add value with the majority of customer interactions. It is recognized by marketing that 2 percent of customers generate 98 percent of the Banks profits. The Bank is focussing on this highly valued 2 percent of customers and seeking ways to increase their market penetrations.

The branch is divided into two functions, sales and service. Sales employees deal in lending and investments whereas service employees deal in day-to-day transactional banking and sales support. Sales staff is evaluated primarily on sales

revenue generation and service staff is evaluated based on customer service satisfaction.

### **Cross Selling Systems**

Cross selling systems are considered a key driver to fully leveraging the benefits of the TD Bank and Canada Trust Merger. Using the following systems, the Bank hopes to earn greater economies of scope.

Economies of scope occur when the Bank achieves cost savings by increasing the variety of goods and services that it produces (joint production). Such effects arise when it is possible to share inputs and to use the same facilities and personnel to produce several products. For example, the Bank may sell creditor insurance with its mortgages in its local branches in order to spread the fixed costs (like the office rent) over a larger number of products.

### **Radar/Leads**

Radar Leads is a basic data mining system that cross references customer demographics with their current product set with the Bank and determines what products the customer may be interested in buying. The next time the customer visits the branch to make a transaction, a lead is triggered and the employee is prompted to initiate a conversation about the target product. This system is designed to increase customer product penetration, which will in turn lead to greater market share and higher profitability for each customer relationship.

TD Leads also has the ability to create referrals to other Bank Division with a consistent referral mechanism for achieving economies of scope. Even though different business units use different software platforms, the web based referral system is accessible from every unit in the Bank and allows consistent communication and tracking of referrals between different business units.

#### **2.3.4.2 Retail Stores**

Retail stores such as Staples and Home Depot offer in-house credit to business customers. Staples bizSmart, was a re-branded product line produced by Amicus Bank, a CIBC subsidiary. CIBC has since discontinued this relationship with Staples.

Apparently the relationship was not profitable.

TDBFG recently disengaged itself from a partnership with Walmart after the US government declined its request to expand in-store branches into the United States.

#### **2.3.4.3 Brokers & Agents**

In the business lending market, brokers and agents primarily offer property secured business mortgages. Unlike bank branches, brokers will source their products from a variety of financial institutions and will receive compensation from these companies based on the volume and pricing negotiated on a product. Brokers can sell the same products that may be available in branches and are often a source of channel conflict. Other Agents sell banking products as well. Car dealerships offer loan financing underwritten by several banks depending on the purchaser's preferences.

TDBFG has several products including mutual funds and mortgages that are sold through brokers and agents. The Bank has regional marketing support offices that are in continual contact with brokers and agents supporting them with information and support for selling the Bank's products. Business loans are not one of the products sold through the broker agent channel.

#### **2.3.4.4 Internet & Telephone**

The Internet has allowed Chartered Banks to offer their full product line over the Internet and telephone. As well, several credit card companies post links to applications for their business credit cards online.

TDBFG employs a department called e.Bank whose purpose is to generate sales through non-branch channels. This includes online ads, telemarketing and direct mail. This channel competes directly with retail branch network, however the Bank recognized that competitors market to customers in the same fashion. The Bank feels that cannibalising customers from the retail channel is better than losing customers to competitors.

#### **2.3.4.5 Direct Mail**

Many monoline finance companies sell products using direct mail. Most often credit cards are sold in this fashion. Banks often offer businesses term loans via direct mail offers.

### **2.3.5 Loan Production & Credit Management**

A unique characteristic of production in lending is that the product is customized and production begins after the first contact with the customer. The customer first applies for a loan, the Bank produces an offer that the customer in turn accepts or rejects. At this point, the Bank has already expended resources and time, but has no guarantee that the customer will purchase the product. If the customer accepts, then the Bank produces documentation, which the customer signs at the next meeting after which the loan is funded. The process can be fairly costly.

#### **2.3.5.1 Credit Management**

At TDBFG, Credit Management provides effective risk management for the loan portfolio within quality guidelines while acting as an advisor through ongoing communication and sharing of information with the distributions network. Credit Management has a mandate to provide approvals or suggested alternatives in a timely manner and assist in the developing the distribution channels and their ability to understand credit decisions.



Credit Management's primary responsibility is to protect the Bank's assets and ensure consistent application of the Bank's lending policies. A key responsibility is to maintain the loan portfolio within established quality guidelines. Through ongoing dialogue Credit Management provides coaching and guidance to branch staff in structuring new and existing deals, adjudicate loans, monitor branch performance and participate in setting up new policies, procedures and systems. The Bank considers its Credit Management processes and systems to be superior in providing quality decisions at the lowest cost. The Bank uses a combination of automated approvals and underwriter review. Deals rejected by the automated system are forwarded to an underwriter for review. Credit Management is a cost centre and is a great contributor to bank efficiency though its ability to provide quality decisions and credit reviews at a low cost to the organization. The Bank has licensed automated decision making software to process approvals on more straightforward deals so that high paid underwriters can focus on deals which require greater analytical ability. This area is also considered a contributor to cost efficiency for the Bank.

#### **2.3.5.2 Credit Administration**

Credit Administration, at TDBFG, handles all support activities related to the Bank's credit portfolio. These are divided into Loan Accounting, Non-Negotiable Security, Compliance Functions, Mortgage Administration, In-House Legal and Commercial Banking.

Loan Accounting handles the data input and disbursement of funds for unsecured, secured and small business credit. The Non-Negotiable Security department prepares all legal documents and forms, related to credit products, and sends them to the originator of the loan. Compliance verifies executed documentation and rejects documents with errors and omissions. Compliance is also responsible for

monitoring margined security, registering government guaranteed loans, administering renewals and issuing letters of guarantee. Mortgage Administration handles all aspects of a mortgage after the documents have been signed and the mortgage registered. This involves verification of documentation, discharges, tax reporting and monitoring of arrears. In-house Legal is a service provided by the Bank to customers, which can provide collateral mortgage charges at a pre-negotiated low price. This reduces the cost of legal service to the customer, but also allows the Bank to waive legal fees for promotion and campaigns. Finally, Commercial banking provides credit administration services for all aspects of the Bank's commercial loan portfolio. This is considered a cost centre and linked to the Bank's core competency.

### **2.3.6 Service**

Service is provided through four channels: branches, retail location, Internet and telephone help lines.

#### **2.3.6.1 Customer Service Indexing**

CSI is a scorecard based on customer surveys measuring their perception of service from the Bank. The questions asked are based on the Voice of the Customer (VOC) research, a survey of consumers of all financial institutions in Canada. The research from VOC reveals what is important to customers when choosing a financial institution and, for the most part, their choice is based on how well they were served in the course of an interaction with staff.

Some of the attributes of a satisfactory service interaction are:

- Using a proper greeting (e.g., "Good Morning/Afternoon, how may I help you?").
- Introducing yourself by name.

- Smiling at your customer.
- Establishing eye contact with your customer.
- Wearing your legible name tag.
- Listening to your customer's request.
- Confirming/restating the details of your customer's request.
- Asking your customer questions about their needs.
- Giving your customer advice or making recommendations based on their needs.
- Treating your customers with respect.

These attributes give the customer the perception that we know who they are, they have our undivided attention and we appreciate their business. Overall these attributes give the perception of a comfortable banking experience.

### **2.3.6.2 EasyLine**

EasyLine allows customers to conduct day-to-day banking over the phone using both an automate service as well as with customer service representatives. They also have access to apply for credit and investment products as well as executing mutual fund transactions.

### **2.3.6.3 Customer Cares**

The Bank aims to provide a premium level of service, however it recognizes that service issues will arise in the normal course of business. To ensure that the Bank is doing its utmost to provide the highest level of service the Bank has created the Customer Problem Resolution (CPR) Process. This process also recognizes that customers whose complaints are dealt with quickly can become some of the most loyal

customers to the Bank. The customer problem resolution process is the Bank's way of ensuring that client problems or concerns are addressed in a consistent way. Most customer concerns are successfully resolved at the branch or business area level. The CPR is also built on the premise that the customer should only have to explain his/her problem once, and that from then on TD staff will relate the issue to one another if it is escalated to a senior officer in the branch, district or ultimately the Ombudsman. An issue is escalated if clients are not satisfied with the solution presented by the front line staff, at this point the Manager or Business Unit Leader will become involved and will attempt to resolve the situation. If the client is not satisfied with the solution received from the first level, Manager or Business Unit Leader, then the Manager will offer to elevate the problem, communicating all relevant details on the client's behalf, to a representative of the Senior Management Officer responsible for the branch or business unit. Problems escalated to senior management negatively impact the branch scorecard. Alternatively, if the client prefers to elevate the problem him or herself, the Manager will provide contact information for a Senior Management Officer. If the problem or concern remains unresolved after branch manager and district manager have attempted to settle the issue, the client may contact the TD Ombudsman.

## **2.4 Competitive Analysis**

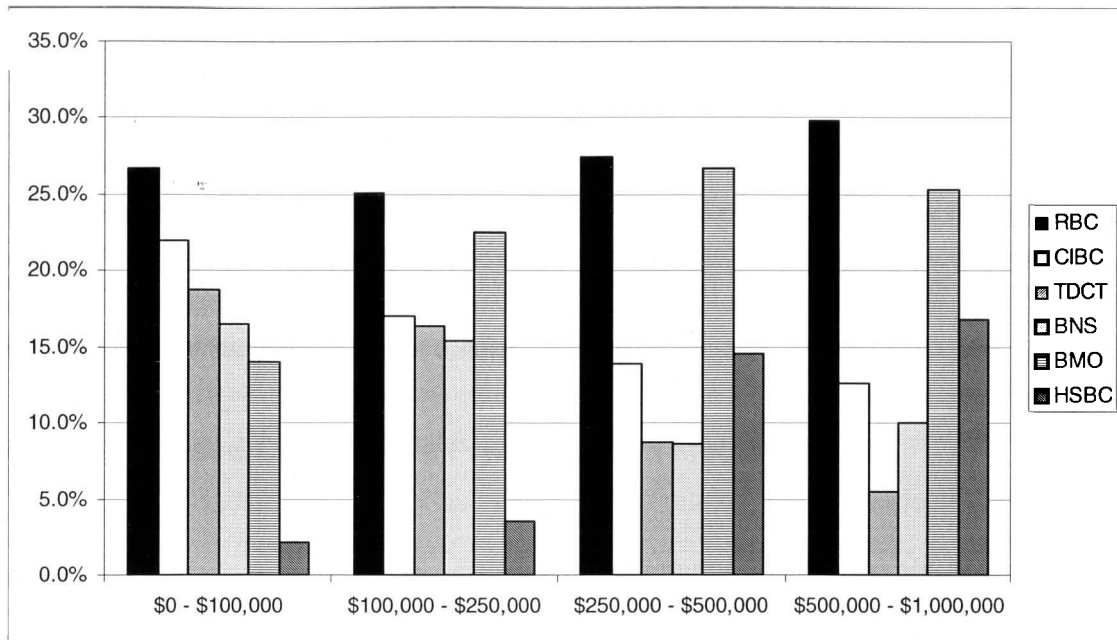
The immediate competition to the TDGBF consists of the four other large domestic banks and the credit unions. This is a mature market where market share gains are primarily made at the expense of the competition. As per Table 4, Royal Bank and Bank of Montreal hold the highest market shares, together holding almost fifty percent of bank loans to the SME market.

	Specialists				Generalists
Category	CIBC	BMO	RBC	BNS	TDCT
<b>SBB Definition</b>	<\$5MM sales <\$1MM credit needs	<\$5MM credit needs	<\$1MM credit needs	<\$1MM sales <\$250M credit needs	<\$1MM sales <\$250M credit needs
<b># of Customers</b>	470,000	438,000	550,000		545,000
<b>Market Share SME Lending</b>	14.4%	22.2%	26.4%	9.8%	9.2%
<b>Market Share Total Assets</b>	16.9%	16.2%	25.2%	16.9%	18.6%
<b>Distribution Model</b>	1,300 small business advisors in branches	Account managers reside in branches	1,200 business bankers	600 SBB Account Mgrs and SBB resources centre	All branch salespeople 100 SBAs with little SBB focus

**Table 4: Analysis of small business banking at the 5 largest Canadian banks<sup>29</sup>**

In Small Business Banking, Canadian Banks are divided into specialists and generalists; Bank of Nova Scotia has a blend of both tactics. It is worth noting that TDBFG has separated small enterprises from medium enterprises, all other banks save BNS have not, and use the same distribution channels to service both sub-segments of the SME market. TDBFG has intentionally differentiated itself, and this has earned it great success in micro lending under \$25,000, Figure 11 reveals good results in credit ranges under \$250 thousand but relatively poor market share results from \$250 thousand to \$500 thousand and very poor results from \$500 thousand up to \$1 million. At first glance, it would appear that the generalist approach is sufficient for credits with low sophistication, however deals requiring greater expertise require SME specialists to be in contact with the customer.

<sup>29</sup> Source: Small Business Product Group



**Figure 11: SME lending market share statistics**

Royal Bank is the market leader in SME lending and has historically done well leveraging its large personal customer base to gain market share in business lending. It has a similar strategy to TD Canada Trust’s personal banking, focusing on the customer experience with a focus on employee responsiveness.<sup>30</sup> From a positioning standpoint, RBC positions its brand to represent trusted banking professionals, whereas TD Canada Trust positions itself as the friendly neighbourhood bank. Bank of Montreal and HSBC are stronger in the higher credit ranges, but lag in the small business segment. BMO is focused on process improvements and lags RBC and TDCT in brand recognition.<sup>31</sup> The Bank still has significant growth potential in the small business segment and has very considerable opportunities in the medium enterprise segment.

<sup>30</sup> Royal Bank of Canada. *2003 Annual Report*.

<sup>31</sup> Bank of Montreal. *186<sup>th</sup> Annual Report 2003*.

### **2.4.1 Competitive Concentration is high**

Competitive concentration is high in the debt financing market. There are five domestic banks and one foreign bank that dominate the Canadian banking landscape, and generally these players try to avoid competition on price alone. The retail banking industry has a balanced mix of competitors. Apart from large banks there are medium and small sized banks and credit unions.

### **2.4.2 Increased Competitive Pressure from Mature Market.**

The Canadian banking industry is a mature market with an expected growth rate between 5 percent and 7 percent. Existing firms compete for market share at the expense of competitors. Market share gained using aggressive pricing, loose credit policy, high service levels and marketing. The costs of these tactics tend to erode bank margins.

All Canadian banks are investing in cross sell technology, to identify sales opportunities. This is in recognition that the additional revenues gained from cross selling existing customers, has a lower cost of production than revenues derived from new customers.

### **2.4.3 Commoditization of Banking Products and Services**

Government regulation and online banking has increased the transparency and comparability of banking products. There is very little differentiation between the product offerings of different banks. Both borrowing and investment products are fairly homogeneous. This limited differentiation creates competitive pressures in the market.

Banks have attempted to counteract the competitive effects of a homogeneous product line by developing stronger brands and differentiating their service delivery. These efforts and a renewed focus on relationship selling have met with mixed success.

As mentioned earlier, TD Canada Trust has successfully combined the low cost sales culture of the pre-merger TD Bank and service culture of Canada Trust. The Bank is using its reputation for exceptional service to differentiate its product distribution. Even though the products are homogenous, product delivery can be differentiated without sacrificing cost effectiveness and productivity. The service culture is well entrenched in the personal banking business which ranks second to the Royal Bank in market share. The culture is not well entrenched in the Commercial bank. The Commercial bank market share ranks in fifth. This is partly a product of history, since Canada Trust did not have a large business portfolio when it merged with TD Bank, as a result, the merger augmented the retail book but left the commercial book relatively unchanged.

#### **2.4.4 Technology Enables the Easy Switch**

Regulation and technology have enabled banks to switch customers from competitors more easily. Using the inter-bank clearing system, banks can ensure your cheques from a former bank service supplier will be re-routed to the new bank account.

A majority of Canadian banks have contracted out account switching services to Davis & Henderson. Davis & Henderson is the dominant supplier of micro-encoded cheque printing services and has close ties to most major Canadian banks. As switching banks becomes easier, and account acquisition tactics will necessarily lead to higher churn rates, which reduces bank margins on product acquisition, but leads to healthy revenue growth for Davis & Henderson. The resulting reduction in switching costs places increased competitive pressure on industry players.

#### **2.4.5 High fixed assets costs**

Banks have high fixed costs for the branch network and sunk costs for setting up business systems. This increases rivalry because the marginal costs of an additional



product sale are low. As well, increased capacity from opening a new branch results in aggressive customer acquisition tactics in order to build sufficiently large revenue generating customer base to cover the branch's fixed costs. TD Canada Trust has slowly divested itself of most of its fixed real estate, opting for long term leases rather than tying up capital in real estate.

#### **2.4.6 Brand Equity Costs and Political Barriers to Exit**

Canadian Financial Institutions carry a portfolio of businesses and most banks share common branding across their business units. As a result, exit from one business segment or geographic area signals a bank weakness and gives the appearance of lack of concern for community access that can reflect negatively on other business units. This negative perception of the group brand weakens the group brand equity.

As well, exit from a particular business or geographic segment usually entails branch and office closures, as well as layoffs. Since banks are significant employers in the Canadian economy, it is not unusual for government to intervene or enter into discussions with a bank to maintain employment and access to banking services to Canadian consumers.

### **2.5 Key Success Factors**

Succeeding in the SME lending market hinges on the following key success factors.

#### **2.5.1 Culture**

Culture is a powerful tool for people development, and strong consistent culture in a large bank like TDBFG can be a sustainable competitive advantage. This is because it is difficult to change the culture in a large organization and as a result a successful culture is difficult to duplicate.

The Bank must develop a customer focused culture, which rewards business development and encourages lenders to lend freely within guidelines. Relationship managers should be readily available to their customers and deliver consistently comfortable customer experience with full transparency to the financing process. The amount of time spent in contact with customers and prospective customers should be maximized.

Business lenders have traditionally been hired and rewarded for their analytical skills rather than sales and business development ability. As well, lenders within TDBFG serving medium sized businesses that have underwritten deals that subsequently go bad are penalized, even if the fundamentals of the deal at the time of approval were sound. This leads to overly risk adverse behaviour. The culture within the Small Business lending group is not uniform. There is a mix of sales oriented Small Business Advisors as well as others who are more reactive. TD Canada Trust is recognized for its strong service culture in its personal banking business, and it has preserved the sales focus inherited from TD Bank. The Bank needs to map this culture to the SME Banking Group. Since there are relatively few SME relationship managers at this time, the process of culture change will be easier than for TDBFG's competitors.

### **2.5.2 Marketing**

Individual campaigns and product specific advertising will meet with limited success unless they are part of a coordinated marketing plan directed at the SME market and its sub-segments. To gain marketing momentum, the Bank must present a consistent identity to the SME market. It must also develop seamless relationship management between small enterprise and medium enterprise lending.

Presently, medium enterprises are served by the commercial bank and the personal bank and Small Business Banking Group share responsibility for small

enterprises. The commercial bank spends limited funds on marketing and small business lending is only one of many products offered by the personal bank. TD Canada Trust has excellent brand recognition in the personal market, however SME customers are not aware that that same brand image applies to their market as well. The Bank needs to direct a similar brand consistent marketing program toward this market segment to increase awareness.

### **2.5.3 Sales & Distribution**

Distribution should be focussed on the target market and should be seamless and transparent to the customer. As well, SME customers repeatedly communicated to the banking community that they would like relationship managers with sufficient expertise to handle their relationships.

Presently, the Bank has two separate bricks and mortar distribution channels for business banking. The retail branches with their Financial Advisors and Small Business Advisors serve the micro business and small enterprise market. A sales support team provides retail branches with training and advice.

The commercial banking hubs serve the medium enterprises, mid-market and junior corporate. Micro businesses are also sold products via direct mail and telephone marketing.

There is no clear focus or accountability for sales and distribution to the SME market. The reporting structure for the people in the retail branches culminates at the regional level, the small business sales and support group report nationally, and the medium enterprise group reports to a regions, which do not match the retail bank regions. At the branch level, managers are rewarded for meeting revenue and volume targets regardless of whether these are met selling personal or business products. Similarly, the commercial bank's performance includes revenue and volume from

medium enterprises, mid-market and junior corporate, the smallest of these being medium enterprises.

There are approximately 100 business specialist in direct contact with small enterprises. RBC and CIBC have 1200 and 1300 respectively. Assuming they have traditional SME lending cultures, these specialists spend less than half their time in direct contact with the customer and are otherwise occupied with renewal and maintenance tasks. These tasks provide less value to the Bank than a relationship building meeting devoted to understanding the customers' banking needs and selling additional services. Once again the SME Banking Group can learn lessons from the more competitive personal banking market. The SME Banking Group will need to increase the number of relationship managers and locate them closer to the business customers. The personal banking group has superior sales skills and these skills must be instilled in the expanded SME Banking Group. Processes must be improved to reduce administrative duties for SME Bankers and ensure they spend their time engaged in activities which provide the greatest value added to the Bank.

#### **2.5.4 Systems and Processes**

Systems and processes should be aligned with the business culture and reinforce the value creating activities.

At TDBFG, loan approvals for micro loans can be instantaneous, however SME loan approvals can take anywhere from 4 hours to a week. In the case of small enterprise loans, this process may take longer depending on the expertise of the employee in contact with the customer. As well, approval for merchant services must be obtained separately from loan approvals. A customer, who grows from a small enterprise to a medium enterprise and as a result is transferred from the personal bank to the commercial bank, must be re-approved for their credit facilities and vice versa.

TDBFG's aim is to provide product fulfilment at first point of contact. Processes should be implemented to support this goal. Customer credit information and relationship management Information should be scaleable and transferable between market segments and business units. IT should also enable the organization to maximize the benefits of credit scoring and reduce process costs of approval and credit review.

Cross selling business products to existing personal customers is a great opportunity for financial institutions. This especially holds true for TDBFG whose market share in personal product is more than double its market share in the SME market. TDBFG must identify SME cross sell opportunities among TDBFG's personal customers and existing non-borrowing SME customers, and leverage these relationshipd to gain market share.

### **2.5.5 Credit Policy & Risk Management**

To succeed in SME lending, a bank must balance sales growth against risk management. Credit policy should require only the due diligence necessary for the loan decision. Risk Management should be equally accountable for fast turnaround of credit decisions as for controlling risk, and the credit process must be transparent and consistent to the customer.

The small business lending credit group is tracked on turnaround and approval statistics, however the medium enterprise lending group risk management (GRM) is less accountable. This one group reviews deals anywhere from \$250 thousand to \$50 million. Understandably this group cannot be expected to spend a similar amount of time on every deal.

## **2.6 The Current Strategy**

TDBFG's current strategy to address the small business market is a low cost producer strategy. The company has made ongoing efforts to reduce production costs

and has made only limited investments in new product development. Instead of expending resources on new product development, the Bank has utilized strategic partners to expand its product line. The medium enterprise segment is served differently. The commercial bank has raised prices to preserve margins, but has not significantly reduced cost of production. This has created friction when customers are transferred from small business banking to medium enterprise banking, because increases in credit requirements result in a jump in interest rates and fees.

The Bank has taken steps to reduce cost structure for deals in the \$250,000 to \$500,000 range by scaling down the existing Domestic Commercial Credit Review (DCCR). The revised DCCR requires less detailed analysis and allows faster completion of credit requests. This is accompanied with reduced pricing for this market segment, however its pricing in this market is not low relative to the competition. Under the current strategy the Bank can expect to gain market share in micro lending, but continue to lose ground in small and medium enterprise lending.

## **2.7 Core Strategy**

TDBFG has one primary strategy in the business lending area. This involves building shareholder value by maintaining a core competency as the low cost supplier, preserving margins with low production costs.<sup>32</sup>

However given that the Bank's intended goal is market penetration in the short to medium term, the current strategy alone will not result in the intended outcome. As well, given that SMEs are not particularly price sensitive, offering a low cost, no frills service is unlikely to result in a dominant market share.

As well, the authority and structure of the business units involved in SME lending are not centralized, yet to remain consistent in the low cost strategy a more focused

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<sup>32</sup> Porter, Michael E. *Competitive Strategy*, 1980

reporting structure is in order. TDBFG must find a strategy, which will preserve its low cost production but allows the Bank to outperform the competition in the acquisition and retention of SME borrowers.

In order to gain SME market share the Bank must engage in a rapid penetration strategy. This paper presents two distinct alternatives, depending on the Bank's capabilities and commitment.

## **2.8 Optimal Rapid Penetration Strategy**

In order to gain market share in the SME lending industry TDBFG should adopt a rapid penetration strategy based on providing greater value while matching the lower range of the competition's prices. This is in line with the personal bank strategy and the TD Canada Trust brand. As well price demand is relatively inelastic, therefore lower prices may result in some market share gains but they would be at the expense of net income. This would also attract the sub-segment of this market that is price sensitive and if prices were subsequently raised, these customers would leave the Bank.

Customers do value a comfortable banking experience and since delivering that experience is not easy to duplicate, this is a sustainable strategy for the SME Banking Group. The benefit of this strategy is that the sales and service culture is more difficult to duplicate in SME banking, because the TDBFG's competitors have incumbent administration and analytics focused cultures serving that market segment. The customer experience strategy will be supported by market development and product development. The profitability of these strategies will be preserved as a result of TDBFG's protection and enhancement of its core competency as a low cost producer.

A portfolio of tactics will support the comfortable banking experience. These include creating a customer centric sales force focused on the SME market segment that will manage the customer relationships. The bank will engage in process improvements

to increase the speed and transparency with which financing requests are processed. The Bank would launch a strong advertising and promotion campaign targeted at the SME market to increase awareness of the TD Canada Trust value proposition. This strategy will win customers from TDBFG's competitors and increase existing SME retention. Finally, development of the SME market will be achieved by cross selling SME banking services to existing personal customers who are also business owners, while product development will focus on asset lending.

The combination of these strategies should result in rapid annual market share gains in the medium term with continuous product development.

### **2.8.1 Culture**

TD Canada Trust has a strong sales and service culture, whereas TD Commercial Bank has stronger roots in analytics. In order to create a culture based sustainable competitive advantage in SME lending, TDBFG should create a customer centric culture in all business units involved in SME banking.

Similar to the personal bank, the business banking area needs to deliver a consistently comfortable customer experience. This is the Bank's primary differentiator and its most powerful tool for gaining new business without using tactics that reduce margins.

### **2.8.2 Marketing**

TDBFG has an enviable marketing machine, which is credited with the development of the TD Canada Trust brand. TD Canada Trust brand has strong recognition for personal banking, however it is not strongly associated with business banking. Once the SME Banking Group is capable of delivering the brand promise, the Bank should expand the brand to represent SME banking too. Then the Bank should continue to build the brand through advertising and consistently delivering the brand



proposition, “a comfortable banking experience”. Marketing will also investigate appropriate job titles for SME Bankers based on market research and focus group research to ensure the titles support the sales environment, culture and image of TD Canada Trust.

**2.8.3 Sales & Distribution**

The optimal strategy has a significant impact on distribution. It involves dramatic changes to structure, performance measurement, and compensation.

**2.8.3.1 Structure**

In order to reduce distribution costs the SME business at TDBFG should adopt a simpler organization structure as well as a more aggressive compensation structure. As per Table 5, the Bank needs to be strict in its focus on the market segment.

TD Canada Trust (Micro Lending)	TD Canada Trust SME Banking	TD Commercial Bank (Medium & Junior Corporate)
<ul style="list-style-type: none"> <li>• Loan authorizations under \$100,000</li> <li>• Day-to-Day business banking needs</li> </ul>	<ul style="list-style-type: none"> <li>• Loan authorization greater than \$100,000 and less than \$1,000,000</li> <li>• Deposit &amp; investment balances greater than \$250,000 and less than \$1,000,000</li> <li>• Cash management services</li> </ul>	<ul style="list-style-type: none"> <li>• Loan authorization greater than \$1,000,000</li> <li>• Deposit &amp; investment balances greater \$1,000,000</li> <li>• Cash management services</li> </ul>

**Table 5: Business Segmentation under Optimal Strategy**

The Personal Bank will serve micro lending needs and customers with straightforward business banking, however customers will have a business banking hotline where they can receive business services over the phone, from a group of telephone agents specialized in business banking.

TD Canada Trust SME Banking would serve more than just borrowing customers. The focus is on the SME market segment and the relationship manager should manage all products that would serve that market segment. SME bankers should be located in retail branches in geographic proximity to their customer portfolio. If there were a concentration of customers in one area then several SME bankers would be assigned to the branch. Career progression in SME banking would relate to the composition of each portfolio of 100 to 200 customers. A SME banker would begin with a portfolio of small businesses and would progress based on his or her portfolio size. As the SME Banker's portfolio grows in size and complexity the number of relationships served would decline. This means that a new SME Banker would have a portfolio of 150 to 200 customers with small credit limits and an experienced SME Banker would have a portfolio of 100 customers with limits in the \$750 thousand to \$1 million. The portfolios would be rebalanced semi-annually, with smaller relationships referred to junior portfolios. There would be no restrictions on the size of new acquisitions. If a new SME Banker brings in a \$1 million client, she will book the deal and keep the relationship. If she requires assistance in structuring and submitting the deal, this will be provided by her manager, however she keeps the relationship.

The corporate reporting structure would also be streamlined. SME bankers would report to district managers who in turn report to one of 9 regional Vice Presidents who then report to the Senior Vice President for SME Banking.<sup>33</sup> The regions should perfectly overlap the 9 personal bank regions and the districts would overlap the 54 personal bank districts.

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<sup>33</sup> Appendix B

### **2.8.3.2 Focus on Small and Medium Enterprises**

In order to gain market share in the targeted SME market segment, TDBFG must ensure that the group serving this market segment is focused on the market segment alone. SME bankers would no longer report to retail branch managers who are responsible for a portfolio of over 200 products and various market segments. SME bankers will report to a District Manager of SME Banking.

SME Bankers will be rewarded for referring business to other businesses of the Bank, however they will not be rewarded for selling products targeted at other market segments. Other business units will also be rewarded for referring business to the SME Bankers.

### **2.8.3.3 Compensation**

SME bankers at TDBFG would have lower salaries but higher performance bonuses than the industry average. The structure would still match average performance to the average market compensation, however TDBFG would have a greater emphasis on performance. Bonuses would be tied primarily to new business acquisition and would be modified by a customer service multiplier based on a Business Sales CSI as well as a volume growth multiplier.<sup>34</sup> This compensation structure would not necessarily lower distribution costs, but it would preserve margins, the culture, and the brand.

## **2.8.4 Systems and Processes**

Systems and processes need to be aligned to the culture and business strategy. This requires modifications to existing Customer Relationship Management systems,

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<sup>34</sup> New business refers to bringing a new customer to the bank and includes cross-selling a SME product to an existing personal banking customer or business customer who presently has no SME products.

investment in Credit Scoring technology, investment in Credit Management systems and moving some processes offshore.

#### **2.8.4.1 Customer Relationship Management (CRM)**

Current CRM systems result in costly duplication. Presently the relationship manager inputs the credit information into the CRM system, however the adjudicator prints out this information and re-enters it into a credit adjudication system, which is used to track and approve the credit. The level of automation is fairly low. If the customer were to request approval for merchant services, a non-credit product, the relationship manager would have to prepare a separate application in paper format and fax it to the merchant services department where the information would once again be re-copied onto a paper based adjudication form. As well, if small business customers graduate to the medium enterprise segment, the relationship manager must complete a new application to approve the customer under medium business guidelines. TDBFG must develop an enterprise wide system for gathering information about business customers. The system should be scaleable and allow for the differences in due diligence required for different types of requests. Different departments may access this information to make their decisions. Ideally the credit platforms will pull needed information off of the relationship management system. Finally, in order to maintain high service levels and process transparency to the customer, the system should allow the customer to know the status of their request at any point in time by login into the internet banking site and clicking on "credit application status".<sup>35</sup> Dell Computers and Amazon.com have pioneered this type of order tracking technology.

For the Bank to take advantage of its higher market share in personal banking, any customer relationship management (CRM) system must be tied to, or an extension

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<sup>35</sup> See Appendix C

of, the personal CRM system. The personal CRM system not only maintains customer information and assists employees in the sales process, it also feeds data directly into the credit application system. The Bank should increase the scope and functionality of this system to handle SME customers.

#### **2.8.4.2 Credit Scoring Technology**

Developing credit-scoring technology in-house would be a high risk and costly endeavour. In the short run, TDBFG will have to purchase credit-scoring technology and customize it to reflect its low cost objectives. Given that this technology will likely be a long-term key driver of production cost, TDBFG should investigate the acquisition of a credit-scoring technology provider or a foreign bank with a superior platform in order to gain control of the technology and future enhancements.

#### **2.8.4.3 Credit Management Technology**

As a result of levels of low automation in Credit Management Technology for small business credit, in 1999 the Bank consolidated several regional credit centres into two centres that serve all of Canada. Consensus in the industry indicates that local knowledge increases the quality of credit decisions made. As the credit process becomes more automated and customer information is stored electronically rather than paper files, the Bank will have the opportunity to pilot satellite credit centres. These would be small credit offices with as few as 10 underwriters located in high volume areas. As a result of automation, they could handle deals from outside their area if they are below capacity and could hand off deals to other centres if they are over capacity. It would ensure that deals that make good business sense in a local context would be approved without increasing production costs to the Bank. The current large centres are located in Edmonton and Markham and could have satellite offices in smaller urban

centres around the country. The decision to locate a centre would be dependent on the volume of credit requests received from that area.

#### **2.8.4.4 Cross selling personal and existing non-borrowing customers**

The Bank has existing cross sell technology, which is presently being used to sell additional products existing TD Canada Trust customers.<sup>36</sup> This technology has been used to target micro businesses and to a lesser extent small businesses, however it has not been used in a focused manner to target the SME market.

This technology would be used by the SME banking teams to identify prospective customers with a high likelihood of needing SME banking products and a high likelihood of being approved for credit products.

#### **2.8.4.5 Outsourcing or Offshoring**

Throughout the application, adjudication, loan production and subsequent monitoring of SME borrowers, there is a great deal data inputting and administrative work, which can be performed remotely. In order to reduce cost of delivery and provide personalized service to smaller customers, the Bank should explore using offshore and outsourced services. For example, financial statement analysis generally involves transferring the information from the customer's financial statements into a software package, which then produces the ratios and figures necessary for a credit decision. This data input process could be handled at a remote site. The documents would be faxed to the site along with any comments needed to clarify ambiguity. The data input would take place off site. Likewise with monitoring of inventory, accounts receivable and accounts payable. These reports could be faxed directly to the remote site.

Citigroup presently runs call centres and processing centres in India and has had a presence there for years. American Express, ABN AMRO and HSBC have all set up

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<sup>36</sup> Leads & RADAR

operations in India as well. Offshoring not only results in lower costs, but also 24/7 operational capabilities. Documentation for SME credits could be prepared at a remote location and sent to the relationship manager as an Adobe Acrobat file to be printed and signed by the customer. Presently, documentation preparation can take up to two days.

There are operational and reputation risks to shifting operations offshore, however, as evidenced by the number of banks already engaged in this activity, these risks are manageable. Current trends suggest that use of offshore capabilities will be necessary simply to maintain the Bank's low cost leadership.

## **2.8.5 Credit Policy & Risk Management**

In order to gain market share, the Bank should develop products that SME borrowers use, but that have traditionally been outside the banks' credit guidelines.

### **2.8.5.1 Asset Lending**

The one product area that presents the greatest opportunity is asset lending. Considered higher risk by banks, because of its reduced reliance on historical cash flow, asset lending has been profitable for other financial institutions including some smaller Canadian banks. Asset lending focuses on four types of assets: Inventory, Accounts Receivable, Equipment and Land & Buildings.

TDBFG should develop products targeted at financing these assets or purchase businesses that are already profitably engaged in this type of financing. Whether the Bank sells these products in-house or acts as a broker agent for another company, offering these products through the SME banking distribution channel will build TDBFG's reputation and signal to the market that it is an aggressive player in the SME lending arena.

A conservative product addition would be re-launching margined lines of credit to customers with limits in the \$250 thousand to \$100 thousand range. This product usually margins a percentage of accounts receivable, inventory or marketable securities but was discontinued in 1998 due to the high monitoring costs that made it unprofitable. Cost reducing alternatives may make this a viable product.

#### **2.8.5.2 Automotive Financing**

An extension of new product development is modifying existing personal products to serve the SME market. Presently TDBFG offers vehicle financing to individuals through car and truck dealerships nationwide. Often SMEs will finance company vehicles in this fashion because of convenience. TDBFG should expand this product to include vehicle financing. Likewise, the personal bank has developed a loan product, which simulates a vehicle lease. This product could also be expanded to be available to SMEs.

### **2.9 Alternative Rapid Penetration Strategy**

The alternative strategy will result in market share gains, however it involves serving a niche of the SME market and embraces fewer of the key success factors identified earlier in Chapter 2. In order to gain market share in the SME lending industry with a conservative organizational and capital commitment, TDBFG should maintain the existing rapid penetration strategy used for small business customers with the lowest price in the market and relationship management for small enterprises handled Financial Advisors. The product line and application process would be simplified so that SBAs can be phased out, as they are more expensive than Financial Advisors and employees of lower expertise can sell the simplified product. This would be coupled with a market development strategy leveraging the cross sell opportunities presented by the larger market share in personal banking. This strategy would be supported by process



improvements and credit scoring technology in order to reduce costs and reduce the need for expertise in the sales force. TDBFG would retain a generalist approach to managing the customer relationship and advertise its through low cost channels. Finally, the bank would look for opportunities to modify personal banking products to be sold to SME customers. These modified products would be sold through alternate distribution channels such as car and equipment dealers. Medium enterprises would continue to be served by TD Commercial Bank.

This strategy would focus on and retain low risk small business customers whose credit needs are simple and require little monitoring. These simplified products would filter out small business customers who do not fit the generalist profile. This strategy would retain its targeted small business sub-segment and over time would attract low risk, price sensitive customers from other institutions. Customers would also benefit from having one contact for all their personal and business banking needs. The commercial bank would pursue a similar low cost and low price distribution strategy, however a relationship manager specializing in medium enterprise lending would serve these customers.

Price demand is relatively inelastic however there is a sub segment of SME customers that is price sensitive and will switch. As well, many SME customers want to deal with relationship managers who have expertise, which this strategy will not provide. This strategy will result in rapid short-term market share gains however as a niche player TDBFG will not win a dominant market share. The benefit of this strategy is that other banks cannot match the low prices without dismantling their high cost distribution channels. Its weakness is vulnerability to a new entrant who does not share the cost of a bricks and mortar distribution channel.

### 2.9.1 Credit Scoring Technology

TDBFG will have to licence credit-scoring technology and customize it to reflect its low cost objectives. Customization will be kept to a minimum to reduce maintenance and upgrade costs to the system.

### 2.9.2 Credit Management Technology

There is a great deal of duplication in the credit management area. Credit management technology presently results in costly duplication. An interface would be developed for SME bankers so that the data they input is automatically fed to the credit scoring system without having to be input a second time.

### 2.9.3 Organization & Compensation Structure

In order to reduce distribution costs the SME business at TDBFG should adopt a simpler organization structure.

Three distinct groups should service business banking as per Table 6. This is the same market segmentation strategy currently employed by the Bank. TD Canada Trust would service more than just small business borrowing customers. Financial Advisors would manage all products that serve small businesses in addition to the Bank's personal offerings. FAs are located in retail branches in geographic proximity to their customers.

TD Canada Trust Financial Advisor	TD Commercial Bank Relationship Manager
<ul style="list-style-type: none"><li>• Loan authorizations under \$250,000</li><li>• Day-to-Day business banking needs</li><li>• Basic Cash management services</li></ul>	<ul style="list-style-type: none"><li>• Loan authorization greater than \$250,000</li><li>• Deposit &amp; investment balances greater \$250,000</li><li>• Cash management services</li></ul>

**Table 6: Business Segmentation under Alternative Strategy**

FAs would maintain a mixed portfolio of 150 to 200 personal and small business customers. The corporate reporting structure would remain the same for medium enterprise lending, and FAs would continue to report to their Branch Manager.

#### **2.9.4 Product Development**

TDBFG presently offers vehicle financing through car dealerships; this would be extended to business customer, while the credit approval would still be based upon the owner's personal credit worthiness. The same modifications would be made to PAAL loans, which are loans, offered by the bank and simulate vehicle leases.

### **3 CHAPTER THREE: INTERNAL ANALYSIS OF SME LENDING AT TDBFG**

TDBFG's ability to implement either of the above strategies hinges on its internal capabilities. The assessment of these internal capabilities will follow the Diamond E model.<sup>37</sup> The internal analysis will take inventory of the required resources, management preferences, and organizational capabilities necessary to execute the optimal strategy. It will then identify the gap between the necessary and actual resources and capabilities. Finally, the internal analysis will address the gap and determine how TDBFG will close the gap. If it cannot close the gap then it should adopt the alternative strategy, which requires fewer resources and capabilities.

#### **3.1 Resources**

In order to engage in the optimal strategy, TDBFG needs significant resources. Many of these resources are readily available and play on existing strengths at TDBFG. Other resource requirements present significant gaps that need to be addressed.

##### **3.1.1 Culture**

The Bank will be building a 1000 employee distribution network, almost from scratch. The existing network relies of 100 Small Business Advisors and fewer than 100 specialists from the commercial bank who serve medium enterprises. Not all of the existing personnel are suited to the sales and service culture and not all of them will be hired into the new SME banking business unit. Given the large intake of new SME Bankers within a one-year period, the Bank will need to indoctrinate them with the new SME banking culture and the desired customer relationship management model. This

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<sup>37</sup> Fry, Joseph N. and J. Peter Killing. *Strategic Analysis and Action, fourth edition*. Scarborough: Prentice-Hall Canada, 2000. 39-50

will require significant training and team building resources to be placed at the disposal of the SME banking business unit. In the past 2 years, TDBFG has run an intensive one-week training program for managers at TDBFG. This training is similar to that which would be needed for the SME bankers. The week could be modified to suit the new needs and could be extended by one week to allow for technical training on systems, processes and structuring credit. The Bank also has experience indoctrinating the TD Canada Trust culture after the merger as well as the absorption of Laurentian Bank employees.

In order to support this cultural acclimatization, TDBFG must ensure that systems and processes are appropriately aligned to the sales and service culture. This will be explored later in the chapter.

### **3.1.2 Marketing**

TDBFG has excellent brand management experience both with TD Canada Trust and TD Waterhouse. In this case, SME Banking will be brought under the TD Canada Trust brand. This reduces the challenge for SME Banking, because the business unit does not need to build a brand from scratch. It does present challenges, because SME banking must live up the brand proposition. Living up the brand proposition is addressed by the other components of the strategy.

In order to hire SME Bankers, marketing will first have to look at the market segment demographics to create 900 portfolios that are both profitable to service with a relationship manager and have sufficient growth potential. Once the portfolios are created, the territories can be allocated and the hiring process begins.

### **3.1.3 Sales & Distribution**

In the first year the Bank will hire 900 SME Bankers, 100 per region. However they will not be allocated evenly to each region. SME Bankers will be located based on

geographic customer concentrations. Nine hundred SME Bankers is fewer than TDBFG's closest competitors, however the sales force can be incremented to reinforce the geographic areas experiencing the greatest growth.

Potential hires will come from the existing SBAs, medium enterprise bankers, the TD Canada Trust personal banking sales force, other business units and external hires. SME Banking will hire for personality and suitability to the sales and service culture. The 900 SME bankers will be hired in two waves of 450. Availability of suitable candidates is expected to be moderately high.

TDBFG will also need 54 SME District Managers paralleling the existing 54 personal bank districts. These individuals will be expected to have a higher level of expertise, and can be drawn from SBAs, the Commercial bank and SME bankers from other Financial Institutions. The availability of these hires will be moderate, however the Bank has the financial resources to attract the right people.

Finding offices for all of these SME bankers presents another logistical challenge that will be handled by Real Estate Management. Real Estate performs fixed assets management functions. It works with the district manager, and ensures that offices are furnished appropriately and that leasehold improvements are made to address the Bank's needs. Design and construction is fairly straightforward however branches have very specific needs and although some branches have available space to accommodate a SME Banker, some would require expansion or significant renovations. The more capital-intensive proposals would be evaluated to ensure that the Bank would gain adequate return on investment. Real estate management does not present a significant obstacle to this strategy.

The SME specific hotline involves reallocation of existing call centre resources, it also involves SME product and systems training for existing telephone representatives. This is a small shift in functionality.

#### **3.1.4 Systems & Processes**

TD Canada Trust currently uses a Customer Relationship Management solution called Clear Customer Choices (C3). C3 is intended to support customer sales interaction. C3 supports TD Canada Trust's Customer Experience Model and Guiding Principles, and assists with product comparisons and recommendations. It is a customer centric tool that invites the customer into the conversation and allows employees to readily share information. Most importantly, C3 signifies the comprehensive choice of products and services available at TD Canada Trust. C3 can be easily upgraded with enhancements for SME and to capture the information necessary for SME applications for a variety of products.

The Bank has already taken steps to improve credit scoring technology for deals \$50 thousand and under. This will be implemented in 2005 and will assist the Personal Bank in servicing smaller volume customers who will no longer be looked after by SBAs. The Bank should investigate other credit scoring technologies to assist in credit decisions as large as \$1 million. The most cost effective solution will be licensing the technology however, in the future as the Bank gains market share, building the technology in-house may prove cost effective and could become a source of sustainable competitive advantage. Although, the Bank presently lacks credits scoring technology for larger credits, there are many suppliers willing to licence the technology. For example, now that Wells Fargo has exited the Canadian business lending market, it may be willing to licence its technology for the Canadian market alone. Wells Fargo is recognized as an industry leader in SME credit scoring technology. Other foreign

financial institutions will likely entertain the same opportunity to gain additional cash flow from their sunk costs in credit scoring technology.

Credit management must be developed in-house. Credit management ties into risk management practices, credit and loan production processes, all of which heavily impact cost of production. Since cost of production is a core competency at TDBFG, the Bank cannot afford to lose control of this function to a third party supplier. It can however reduce development costs by contracting out some of the less sensitive software development offshore under close scrutiny. Process improvements may involve acquiring the services of management consultants. The Bank frequently uses management consulting services to assist in designing best business practices. Any best practices learned from consultants must quickly be built upon and customized for competitive advantage, since the same best practices gained from consultants are sold to every competitor in the marketplace. As well, advantage can be gained by the effectiveness with which best practices are implemented. TDBFG has a culture that is accustomed to change, given its industry. As a result, it can gain advantage through superior change management and process improvement implementation. The Bank has the tools to overhaul credit management.

Cross sell technology is needed to deepen customer relationships and build retention. The Bank presently uses a system licensed from PeopleSoft called Radar & Leads. In the micro lending arena, this system can identify customers who are likely to want and will qualify for credit products, with 99% certainty of approval. As the SME customer relationship technology is enhanced, the Bank will be able to expand the capabilities of Radar & Leads to identify cross sell opportunities in this market segment as well. This enhancement would be part of ongoing system enhancements. The Bank



currently operates enterprise solutions from both PeopleSoft and Oracle. It may gain greater functionality from consolidating with one ERP provider.

The prospect of licensing and purchasing technology, as well as the possibility of building some process functionality offshore creates significant operational, security and host country risks. The Bank already has a department devoted to outsourcing and third party vendor management.

Since outsourcing involves the transfer of the management of a function to a third party vendor there are operating risks that need to be accounted for. Outsourcing Management is responsible for managing these risks including increased reputation risk, loss of control due to transfer of management to the outsourcer and increased risk of loss of the function or process in the event of outsourcer failure. Outsourcing Management ensures the risk/reward decision of outsourcing is carefully analysed before entering into any outsourcing arrangement. The Bank's current capabilities can manage the incremental licensing and outsourcing arrangements proposed by the SME strategy. The Bank should hire consultants when engaging in offshore outsourcing, since the Bank has limited experience in this area.

Striving to create best in class processes for managing procurement expenditures, Vendor Management is being developed into a centre of competency within the Bank for evaluating, negotiating, structuring and managing supplier relationships and sourcing agreements. To fully leverage the Bank's procurement power, Vendor Management is responsible for negotiating supply agreements, which offer the best combination of service, quality, and pricing, with the objective to reduce the Bank's non-interest expenses by an estimated \$130 million annually. The Bank manages some of its mutual funds, however third parties manage many of them: Symcor handles cheque and payment processing, the Bank partners with Ceridian to

provide payroll services, it has partnered with First Data to provide merchant MasterCard services, Brinks services the Bank's ATMs and processes deposits accepted through them, and Iron Mountain performs the substantial task of categorizing and storing documents, which need to be retained up to seven years. As well, the Bank contracts out a great deal of market research and advertising functions. The list of outside suppliers is very large.

### **3.1.5 Credit Policy & Risk Management**

The Bank has limited experience with asset lending. It does have a subsidiary for leasing heavy equipment however only for unit volumes greater than \$100 thousand and the leasing subsidiary maintains separate distribution. The Bank has developed a lease-like loan for personal customers called a Payment Advantage Auto Loan this is delivered through a partnership with Curomax Corp, which specialized in dealer financing of automobiles, leisure and recreational vehicles, and home renovations. Curomax also contracts its services to RBC, HSBC, BNS and Wells Fargo. The Curomax offering is integrated in the C3 platform.

Similar deals could be struck to allow the Bank to offer factoring, financing of work in progress, and low loan-to-value property financing where cash flow is not evident. It would also allow the Bank to become a more aggressive player in commercial real estate financing for investment purposes. The Bank generally shies away from financing real commercial estate that is not owner occupied.

The Bank has laid down the framework for financing through business partners. This process can be repeated with SME products in mind.

### **3.1.6 Resource Gap**

TDBFG has a large resource base and can draw upon from the whole portfolio of financial services. In 2003, The Bank showed willingness to use these resources when

it purchased all of the Laurentian Bank branches located outside of Quebec and it purchased Boston based Liberty Mutual Group. TDBFG is willing to put the right people in charge and give the access to significant monetary and human capital. There is also recognition within the organization that a significant investment will be necessary in process re-engineering and information systems related to SME banking.

Although some resource gaps have been identified, they are similar to shortcomings the Bank has faced in the past and has overcome. Below in Table 7 is a summary of TDBFG's resource strengths and weaknesses.

FACTOR	Strengths	Weaknesses
<b>Culture</b>	<ul style="list-style-type: none"> <li>TD Canada Trust has a strong training program to support sales and service culture.</li> </ul>	<ul style="list-style-type: none"> <li>Not all existing SBAs and Medium Enterprise Bankers buy into sales and service culture. As a result will not be receptive to customer centric training and coaching.</li> </ul>
<b>Marketing</b>	<ul style="list-style-type: none"> <li>TD Canada Trust has a strong recognized brand and a proven ability to protect and build its brand equity.</li> <li>TD Canada Trust has historically had a successful partnership with its advertising agency.</li> <li>Marketing has experience allocating portfolios to personal Financial Advisors. This experience will help in developing SME portfolios.</li> </ul>	<ul style="list-style-type: none"> <li>TDBFG needs to extend the TD Canada Trust brand to represent comfortable business banking in addition to personal banking.</li> <li>The SME Banking Group needs to be able to deliver the brand promise.</li> </ul>
<b>Sales &amp; Distribution</b>	<ul style="list-style-type: none"> <li>Large pool of suitable candidates to fill new SME Banker positions.</li> <li>Many branches have unused space and can accommodate new offices for SME Bankers.</li> <li>e.Bank already successfully operates telephone support for personal and small business customers.</li> </ul>	<ul style="list-style-type: none"> <li>With the volume of hires in such a short time frame, there is a risk of compromising the personality attributes necessary to preserve the customer centric culture.</li> <li>Some branches will require capital expenditures to accommodate the new positions.</li> </ul>
<b>Systems &amp; Processes</b>	<ul style="list-style-type: none"> <li>C3 is scaleable to suit SME customer relationship management.</li> <li>TDBFG historically maintains continuous process improvements.</li> <li>TD Radar / Leads can be expanded to identify SME cross sell opportunities.</li> <li>TDBGF has experience with outsourcing and vendor management.</li> </ul>	<ul style="list-style-type: none"> <li>The Bank must licence credit-scoring technology to improve credit approval process.</li> <li>Improved credit management must be developed in-house.</li> <li>TDBFG has limited experience outsourcing offshore.</li> </ul>
<b>Credit Policy &amp; Risk Management</b>	<ul style="list-style-type: none"> <li>TDBFG has experience acting as an agent for business partners in order to offer innovative products.</li> </ul>	<ul style="list-style-type: none"> <li>SME products are more complex and create additional process challenges when dealing with business partners.</li> </ul>

**Table 7: Resource Strengths and Weaknesses**

### **3.2 Management Assessment**

Senior management is strongly committed to increasing market share of this customer segment. As the industry becomes more competitive in this mature industry there are fewer opportunities to grow outside of mergers and acquisitions. Interest rate spreads are at historical lows in Canada and banks are realizing that the SME market, if served efficiently, can provide higher margins than other market segments. As well, the market share imbalance between personal and SME banking at TDBFG provides a unique opportunity. Ed Clarke, CEO of TDBFG and Andrea Rosen, Vice Chair of TDBFG and President of TD Canada Trust, have both orchestrated the merger of TD Bank and Canada Trust to form TD Canada Trust. They have also successfully absorbed the over 50 branches recently acquired from Laurentian Bank. Having completed these two large-scale transactions and the organizational alignment shifts associated with them, these two senior executives now have the time resources and the will to oversee a strong strategic initiative in SME banking. They have communicated this intent by assigning one individual, Bernard Dorval to manage the commercial bank, Small Business Division of TD Canada Trust and TD Meloche Monnex. His mandate is to formulate a comprehensive strategy for business banking and prepare that strategy for execution. All of the afore-mentioned executives have backgrounds in banking and would each be very capable of engaging in a strategic reorganization. Their greatest challenge will be developing asset lending.

The greatest potential management barrier to change is the current structure of business banking. Presently, medium enterprises are served by the commercial bank and small enterprises by TD Canada Trust. If both small business and medium enterprises were to be served by one business unit, one of these businesses would lose influence over their market segment. This would have the greatest impact on Paul Douglas, SVP Commercial Banking and Tom Dyck, SVP Small Business Banking,

Merchant Services and Insurance. Neither of business unit leaders had a hand in formulating current business strategy, so they are less likely to resist change. Paul Douglas was recently re-assigned from Investment Banking where he presided over a reorganization of that business unit. Tom Dyck joined the Business Products Group in 2002 after the merger of TD Canada Trust and has experience in several other areas of banking including the personal bank, wealth management and information systems.

### 3.2.1 Management Gap

Management is fully committed to change in the delivery of services to the SME market segment. The executive maintains fairly centralized control over bank strategy. If they buy in to the strategy then everyone in a tactical position will fall in line. Table 8 summarizes management's strengths and weaknesses.

FACTOR	Strengths	Weaknesses
<b>Culture</b>	<ul style="list-style-type: none"> <li>The SME Banking Group will be a division of TD Canada Trust, which already has a strong management commitment to a customer centric culture.</li> </ul>	
<b>Marketing</b>	<ul style="list-style-type: none"> <li>TDBFG recognized the value of the TD Canada Trust brand and its role as a differentiator in the retail distribution network.</li> </ul>	<ul style="list-style-type: none"> <li>Chris Armstrong, the former Chief Marketing Officer for TDBFG, and the architect of the TD Canada Trust brand launch, was moved to New York in spring of 2004 to manage TD Waterhouse USA.</li> </ul>
<b>Sales &amp; Distribution</b>	<ul style="list-style-type: none"> <li>TDBFG is aware of its weaknesses and has publicly committed to turning this business around.</li> <li>Imbalance in market share between personal banking and business banking presents a tremendous opportunity.</li> <li>TDBFG has recently completed two large-scale mergers in the distribution network and has the necessary competencies to undertake more.</li> <li>TDBFG has under performed in the SME market for the past five years and management recognizes that change is needed.</li> </ul>	<ul style="list-style-type: none"> <li>TD Commercial Bank will lose influence over medium enterprise banking.</li> </ul>
<b>Systems &amp; Processes</b>	<ul style="list-style-type: none"> <li>TDBFG is in the process of upgrading many of its systems and implementing process improvements. SME banking could be given additional resources in this strategy.</li> </ul>	<ul style="list-style-type: none"> <li>There is a wait list for systems and process improvements and SME Banking will be competing for resources.</li> </ul>
<b>Credit Policy &amp; Risk Management</b>	<ul style="list-style-type: none"> <li>TDBFG has undertaken similar projects in the past.</li> </ul>	<ul style="list-style-type: none"> <li>SME lending involved greater complexity and may proposals may be met with resistance from Risk Management.</li> </ul>

**Table 8: Management Strengths and Weaknesses**

## **3.3 Organization**

### **3.3.1 Organizational Capabilities**

TD Canada Trust has a cultural fit that is aligned with the strategies presented. The Bank has been preparing for a re-launch of a SME banking initiative and there is an expectation that the individuals currently serving this group will be re-organized. There is a credible public commitment to build the Bank up to first or second rank in market share in Canada. The incumbent SBAs and Medium Enterprise Bankers do not all share the TD Canada Trust customer centric culture. In the past four years since the merger of TD Bank and Canada Trust, their business units have been largely untouched by the changes, which swept the rest of the organization. Although this presents an obstacle, TDBFG presently has less than 200 people devoted to this market segment. Much fewer than the nine hundred dictated by this strategy. Not only are they a minority, but also since the SME Business Group is being created as a new business unit the Bank can ask the incumbents to reapply for their positions within the new organization. Job accountabilities and objectives will change, as well as performance measurement and compensation. Those incumbents who are unsuited to the new business model will be screened, and attempts will be made to find them positions in other parts of the SME lending value chain such as credit adjudication and production.<sup>38</sup> It is important that these individuals still have high service skills even to work in back office functions.

Current training programs are ill suited for SME Bankers. They are either directed toward micro lending or mid-market. Over the past three years, TDBFG has designed new training maps for its management, sales and service people within the personal bank. It will have to use the skills gained in the rollout of the retail strategy to

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<sup>38</sup> This is a trend in banking and ultimately impacts the effectiveness of the back office functions. As the back office absorbs more people who are not service oriented it becomes a less customer centric business unit while the rest of the organization becomes more customer centric.

implement a rollout of the SME Banking strategy, including designing a SME banking learning map and training courses specifically for this group.

Another advantage of creating a new business unit is that in the process of hiring SME bankers, management can ensure buy-in. Management must be up front about the changes taking place and sure that potential members are aware that the new culture espouses observational coaching of customer interactions as well as focused coaching to business objectives. For some of the incumbents this is a significant change in management style.

### **3.3.2 Organizational Changes**

TDBFG, in undertaking this strategy, is making dramatic changes to the way it serves SMEs. It is also making dramatic changes in its reporting structure in order to maintain focus on the market segment.<sup>39</sup> This is not unlike TDBFGs recent restructuring of wealth management. In that restructuring it engaged in a hiring and training initiative in the financial planning division of its wealth management unit. TDBFG has the ability and experience to support a targeted hiring and training program to build its SME banking capabilities.

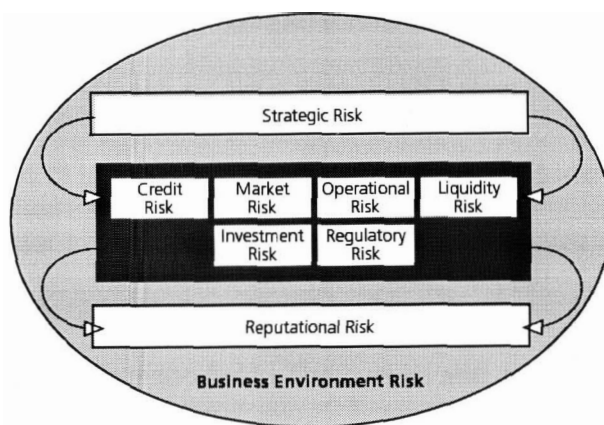
TDBFG also re-organized its wealth management business on a larger scale. It recently brought financial planning and full brokerage services under its TD Waterhouse banner, previously reserved for discount brokerage. They used to operate as separate independent businesses. Now discount brokerage, full brokerage and financial planning all fall under the TD Waterhouse wealth management group re-focusing the wealth management business to avoid channel conflict and extract the benefits of coordinated marketing, relationship management and information systems.

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<sup>39</sup> See Appendix B

That reorganization is similar to the one being undertaken in business banking and it shows that TDBFG has the organizational flexibility to undertake dramatic reorganization.

The SME initiative also involves some risky initiatives, especially in the area of licensing technology, using third party vendors and offshore business functions. The Risk Committee of the Board considers risk and associated trends in risk for the Bank, approves risk management policies, oversees the management of all risks and monitors the risk profile of the Bank. Each business unit is responsible for its own business risk, however these business units report to the Risk Committee. The Risk Committee reviews and interprets risk based on the Enterprise Risk Framework seen in Figure 12. The primary focus of risk management is market, credit and operational risk. To this end, Risk Management must identify risks, articulate them to the business units and provide advice on the shareholders' level of acceptable losses. Risk management then oversees the business units to minimize the level of unexpected losses, and provide an independent assessment of the risk and control infrastructure.



**Figure 12: Enterprise Risk Framework**



TDBFG has the controls to effectively engage in these potentially risky endeavours without placing the organization at unreasonable risk.

Another possible outgrowth of rapid change in the Bank is that business priorities may overshadow regulatory compliance. Compliance is responsible for ensuring that the Bank and its subsidiaries are aware of the legislation and regulations under which they are governed, and that policies and procedures are developed and implemented to ensure that line management is adequately equipped to comply. This is achieved through presentations, participation in department meetings, written circulars and on site surveillance of operating units. Line management is responsible for compliance with regulatory requirements. All line Compliance Officers, while working closely with line management, report directly to the Senior Vice President Compliance. TDBFG has the systems in place to ensure that the SME Banking Group will incorporate compliance into its training and ongoing management of the group.

### **3.3.3 Organization Gap**

The gap in organizational capabilities is greater than the resource gap, primarily due to the shift to a customer centric culture and a new distributions structure. The organizational strength and weaknesses are summarized below in Table 9.

There is a shortage of trained individuals who have experience in SME lending but who also have character traits that make them suitable for a sales and service culture. The skill gap is unavoidable since the objective is to dramatically increase the number of relationship managers in the field. The culture and character gap among experienced employees only serves to reduce the number of people the Bank can hire from existing operations. With comprehensive training and ongoing coaching the skills gap can be closed.

The change in reporting structure appears to be a dramatic change on paper, however the change would impact only the branches that presently have SBAs and the Commercial bank offices. The gap is not that great in practice and is a surmountable obstacle. Three years ago, the SBAs reported to a regional manager and had a similar relationship with the branch as the one proposed in this strategy.

FACTOR	Strengths	Weaknesses
People	<ul style="list-style-type: none"> <li>TD Canada Trust has a strong sales and service culture. Management and people drawn from this group will propagate the culture within the SME Banking Group.</li> </ul>	<ul style="list-style-type: none"> <li>Some SBAs and Medium Enterprise Bankers will resist a sales and service culture. They may not find a place in the SME Banking Group that suits their personal characteristics.</li> </ul>
Performance Measurement	<ul style="list-style-type: none"> <li>Performance will be measured using a balanced scorecard. Emphasis will be placed on customer acquisition and customer service.</li> </ul>	<ul style="list-style-type: none"> <li>This may be a change in performance measurement for team members who do not originate from TD Canada Trust.</li> </ul>
Organizational Structure	<ul style="list-style-type: none"> <li>The reporting structure is exclusively focused on the SME market segment up to the regional level.</li> <li>Since SME Bankers will not reside on a retail branch's FTE, but will generate business for the branch they will be well received as business partners.</li> </ul>	<ul style="list-style-type: none"> <li>There is a risk that not all SME Bankers will integrate well with the retail branch network and gain the confidence of the branch team. Without their confidence, branches will not refer business to the SME Bankers.</li> </ul>
Management Processes	<ul style="list-style-type: none"> <li>One of the cornerstones of the SME Banking Group's management will be ongoing behavioural coaching to the Customer Experience Model.<sup>40</sup></li> <li>Management will also engage in regular focused coaching to business results.</li> </ul>	<ul style="list-style-type: none"> <li>The success of this management approach is dependent on the managers' coaching abilities.</li> </ul>
Leadership	<ul style="list-style-type: none"> <li>The Bank has many suitable candidates for leadership in the SME banking group.</li> </ul>	<ul style="list-style-type: none"> <li>Not all leadership candidates have backgrounds in SME lending.</li> </ul>

**Table 9: Organization Strengths and Weaknesses**

<sup>40</sup> See Appendix D

## **4 CHAPTER FOUR: RECOMMENDATIONS**

### **4.1 Overview**

Ed Clarke has made a public commitment to realizing the potential for market growth in business banking. He has reorganized his reporting structure to ensure Bernie Dorval, who is in charge of strategy for high growth potential businesses, reports directly to him. As well, in the past TDBFG has shown a willingness to undertake swift and dramatic change in order to seize business opportunities.

### **4.2 Strategic Recommendation**

Given the organization's strong commitment to gain market share in the SME banking and more specifically SME lending market segment, TDBFG should undertake the optimal strategy seeking rapid penetration. In order to implement the strategy and bring about change in the organization, senior management first has to communicate its vision for the new SME Banking Group, it needs to create a sense of urgency, and it needs to put the right people in charge of the project. The project team will be the architects of the implementation and must test the design to ensure a smooth implementation. Finally, as the new business unit transitions beyond the start-up stage, systems must be in place to look for opportunities and evolve the strategy as the industry environment changes.

#### **4.2.1 The Vision**

The Bank's commitment will be to provide Small and Medium Enterprise Businesses with the very best service from their relationship manager, in the branch, over the phone and on the Internet. Their business is TD Canada Trust's reason for

being and the Bank appreciates the opportunity they have provided to help meet their financial needs.

Customers demand quick and efficient service and they want to leave with the right product or service the first time. As well, they expect accuracy and for all their financial transactions to be completed error free. They are willing to forgive errors, but only if they are corrected quickly and transparently.

#### **4.2.2 Urgency**

Service excellence is the difference between TDBFG and its competitors. As evidenced by the Bank's depressed market share, the Bank must move quickly to regain its reputation for customer service in the small and medium enterprise market. To do this, the Bank must align its people, structure, products and processes to serve SMEs. This precipitates the creation of the SME Banking Group. All of this must be done while maintaining a low cost operating design. TDBFG cannot profitably deliver exceptional service without maintaining a low cost of production.

Patching will allow the Bank to move quickly to refocus on SME customers, without interrupting existing operations serving that market.<sup>41</sup> Patching involves frequent small reorganizations that keep the organization focused on the strategic objectives but do not involve rolling out the entire strategy at once.

#### **4.2.3 Project Team**

The Bank must ensure that all the stakeholders are represented in the Project Team and that they all buy into the vision. The project management team will be composed of five individuals drawn from the key stakeholders. Some key players include:

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<sup>41</sup> Brown, Shona L. and Kathleen M Eisenhardt. "Patching: Restitching business portfolios in dynamic markets". *Harvard Business Review* May/June 1999: 72-83.

- Business Product Group.
- Insurance Product Group.
- Small Business Credit.
- Group Risk Management.
- Learning & Development.
- Operational Risk.
- Information Systems.
- Retail Sales & Service.
- Small Business Sales & Support.
- Indirect Credit Centre.
- Credit Administration Services.
- Enterprise Technology Services.
- TD Canada Trust Marketing.
- TD Canada Trust Human Resources.

The project management team will involve stakeholders in the design of the implementation plan for the SME Banking Group. The project management team will operate with accountability to reach specific measurable targets with respect to Culture, Marketing, Sales & Distribution, Systems & Processes, and Credit Policy & Risk Management. The strategy must be fully implemented one year after the project management team is formed. Speed is necessary in order to take advantage of momentum. A slower implementation timeframe is more likely to meet with resistance.

#### **4.2.4 The Devil in the Details**

The most challenging aspect of implementing a new strategy is change management. One of the advantages of building the SME Banking Group from an existing combined sales force of less than 200 is that the new SME Banking Group will not be burdened by an incumbent culture and it can hire based on personality and cultural buy-in. The goal is to double TDBFGs market share within four years of successful implementation of the new strategy.

##### **4.2.4.1 People**

A large part of the sales force used to service SMEs will be new hires and trainees. The company should seek out employees within TD Canada Trust whose skill set is complementary to a growth strategy. TDBFG will also look for new hires from outside the Bank however it will not poach business bankers from other organizations as they will, more often than not, bring preconceived ideas as to how to approach the business and may resist adopting the TD Canada Trust culture. To a great extent the Bank will hire for personality. Other skills can be learned. The Bank should seek influencers, individuals who are suited to sales. These individuals are very sociable and prefer working environments that involve a great deal of customer and team interaction.<sup>42</sup>

##### **4.2.4.2 Reinforcement Systems**

Reinforcing desired behaviour is essential to change management. TDBFG will do this by designing a balanced scorecard for SME Bankers and tying it to compensation. The scorecard will be weighted in favour of new customer acquisition. New hires will begin at lower salaries than average with greater rewards for performance, consistent with practices in the personal bank. The weakness of the

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<sup>42</sup> Butler, Timothy and Waldroop, James, *Understanding "People" People*, Harvard Business Review, June 2004, p. 79

scorecard it that it only measures the results of desired behaviour; it does not measure the behaviours themselves. In order to ensure that SME Bankers are developing the necessary skills to succeed, their managers will provide ongoing and frequent behavioural observation coaching. Managers will attend training courses to fine-tune their coaching abilities. Managers will also be observed coaching and their supervisors will “coach the coach”.

#### **4.2.4.3 Systems & Processes**

Systems and processes need to be aligned to the business culture and vision. The goals are ease of use, speed, transparency and low operating costs. The Bank can afford a high initial investment, however the ROI must beat the benchmark. The goal is to meet a service commitment of twenty-four hour turnaround on 80% of SME financing transactions.

TDBFG will add features to its current customer relationship management software to allow it to capture the relevant information for SME lending. This CRM system will interact with proprietary credit adjudication system, which employs a modified credit scoring system. Lending guidelines will be fine tuned to balance sales growth against risk management and credit policy will require only the information necessary for the loan decision. In order to meet the twenty-four hour turnaround target, many intermediary processes will need to be automated and offshore resources employed.

#### **4.2.4.4 Structure**

The structure of the SME Banking Group will be aligned to the market segment rather than product groups or functional areas. Members of product development, credit adjudication and loan production who are devoted to the market segment will all attend the same introductory training as the SME Bankers to introduce them to the vision of

SME Banking and the Customer Interaction Model and their role in the customer experience. This will also allow them to personally meet the other members of the SME Banking team with whom they speak on the phone daily.

In order to maintain focus on this market segment and ensure that its efforts are coordinated with the Personal Bank, the reporting structure for SME Banking will run parallel to the Personal Bank.<sup>43</sup> TD Commercial Bank, now focused on Mid-market and junior corporate, will continue to operate in loose partnership with TD Canada Trust and remain fairly unchanged. The SME Banking Group will locate its relationship managers closer to the business customers in order to maintain the greatest focus on the targeted market segment.

Small business credit adjudication (ACC)<sup>44</sup> will be augmented in order that it may take over the adjudication for medium enterprise lending currently handled by GRM<sup>45</sup>. ACC has been able to serve its market well while keeping production costs low, whereas GRM has been unable to sufficiently lower the costs of the medium enterprise adjudication process in order to maintain a competitive stance. Processes must be improved to release SME Bankers from administrative duties and ensure they focus on customer retention and business development.

#### **4.2.4.5 Skills & Knowledge**

Learning and Development has a principal role in preparing SME Bankers to deliver their accountabilities and objectives. Training will focus on Product Knowledge, Credit Adjudication, Legal Documentation, Sales Conversations and how to incorporate those skills and knowledge into a natural Customer Interaction.

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<sup>43</sup> See Appendix B

<sup>44</sup> Area Credit Centre

<sup>45</sup> Group Risk Management



#### **4.2.5 Vigilance**

Strategy is not static. It is dynamic and will change as a result of future changes in the environment, internal factors and competitors' responses to TDBFGs execution of its strategy.

The Bank must set an expectation that the SME Banking Group remain vigilant to changes that affect strategy and also look for opportunities to leverage its current strategy. Some future innovations might include customized repayment schedules which would peak and trough to match seasonal business cash flow fluctuations but maintain the same amortization. The Bank keeps records of a large percentage of customers' financial transactions and could partner with a financial software company to provide up to date business financial statements through its Website for a monthly fee. The Bank has aggregate data on hundreds of companies in many industries and this information could be sold to customers to assist in benchmarking performance measurement.

#### **4.3 Conclusions**

In a mature market like SME lending that is characterized by high competitive rivalry, market share can only be gained at the expense of competitors. In this scenario a rapid penetration strategy will result in the highest possible market share gain for the Bank.

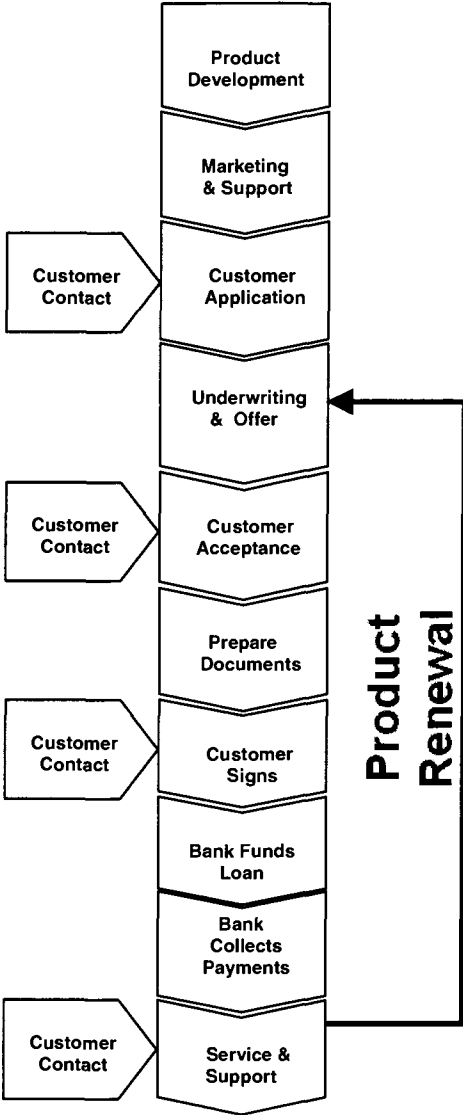
In order to gain SME lending market share it is not sufficient to only match the offerings of the competition. TDBFG must exceed selected capabilities presented by its competitors. The Bank must distinguish itself by consistently delivering excellent customer service to meet its brand value proposition. Excellent service can only be delivered profitably if production costs remain low. TDBFG already possesses an organizational core competency in low cost production. It can transfer these skills to

reducing cost of production in SME lending and allow it to serve customers who would not generate an economic profit for competitors. This, combined with a sales force with superior focus on the target market segment, will enable TDBFG to gain market share. These two primary strategies supported by new product development and superior cross sell systems directed at the personal customer base will lead to success.

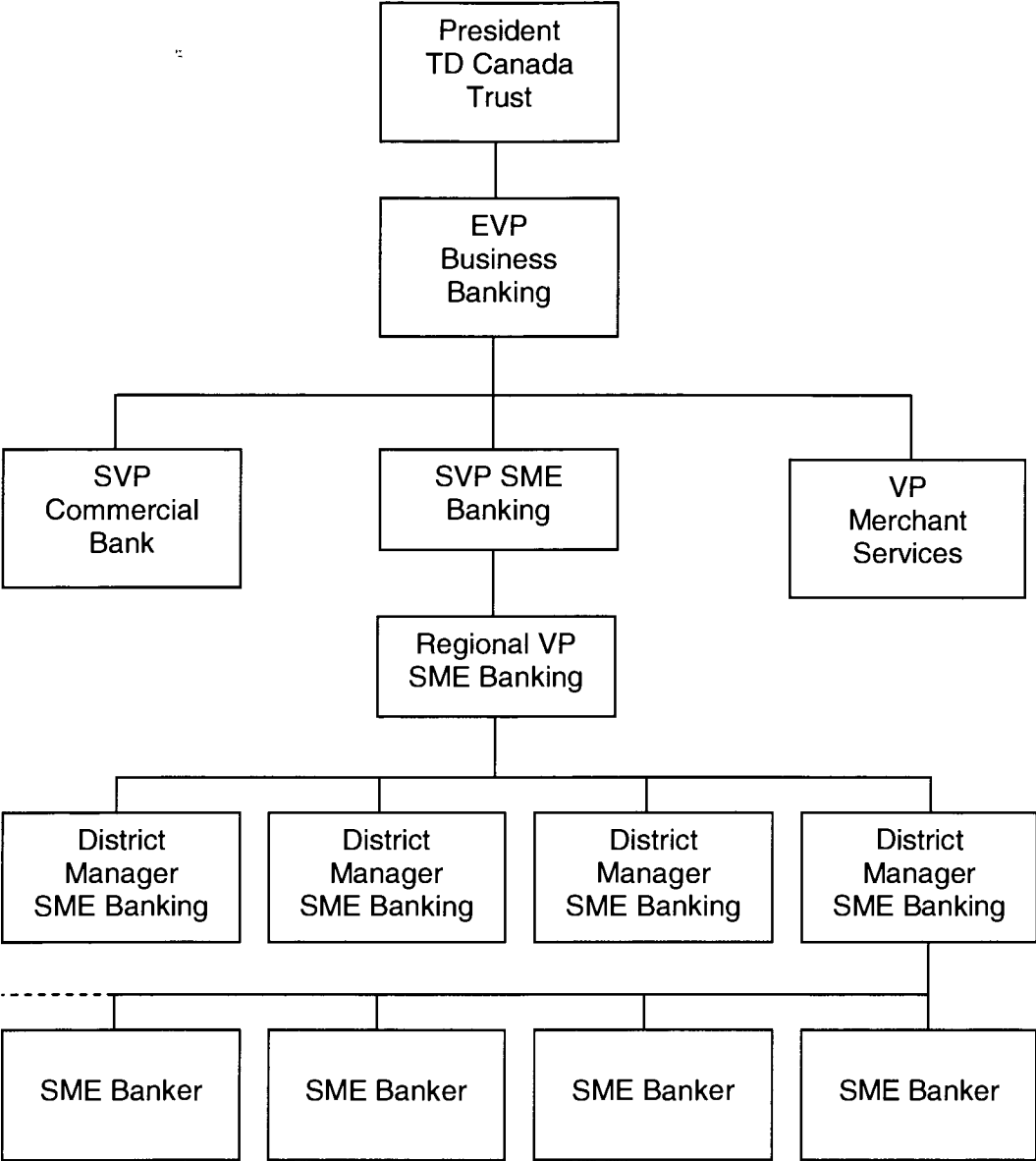
TDBFG has the management support, the resources and an organization that is accustomed to change. With these aligned to the new strategy, TDBFG will succeed in implementing an aggressive and rapidly implemented strategy that will result in increased market share in the SME lending market. Ultimately this strategy is only the next step in SME Financing at TDBFG, it is not a long-term road map.

# 5 APPENDICES

## 5.1 Appendix A: Business Loan Product Life Cycle

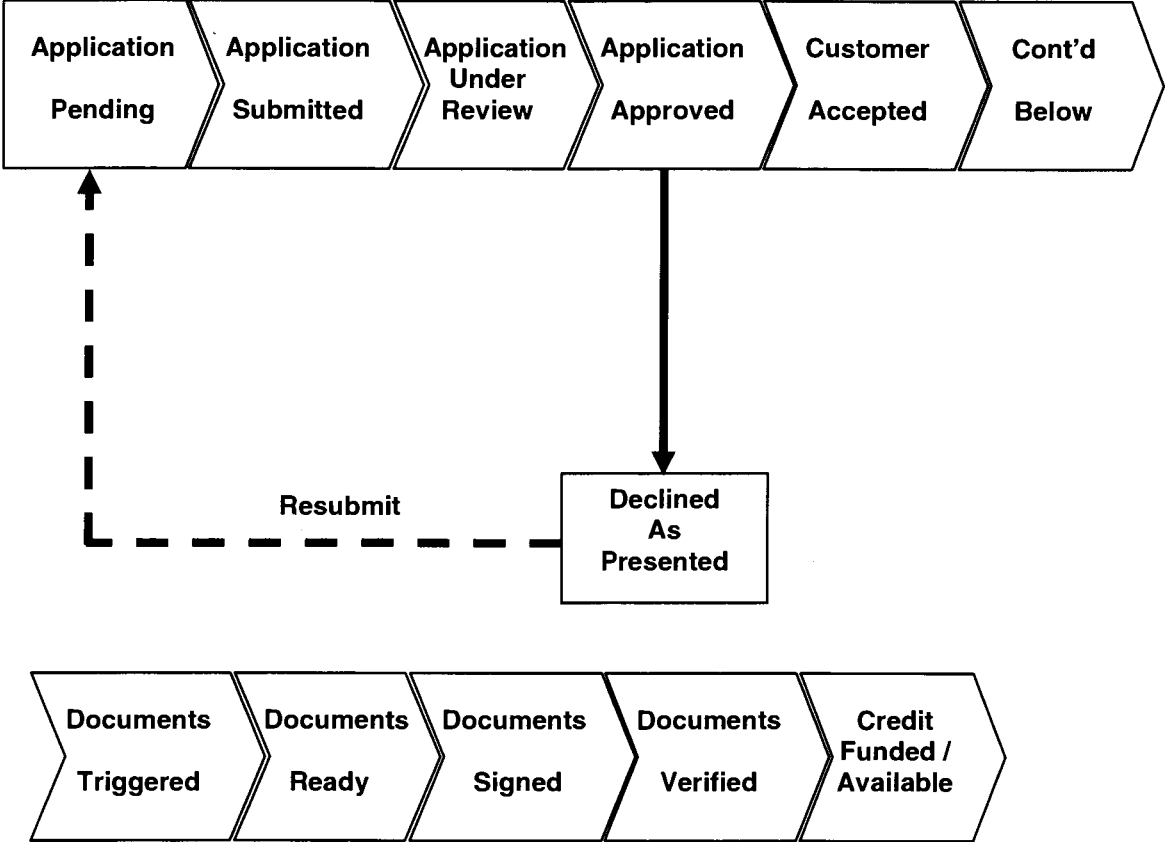


## 5.2 Appendix B: SME Banking Reporting Structure



### 5.3 Appendix C: Loan Application Process Flow

The Website would provide easy to understand explanations of each stage of the process and would also provide explanations of the fundamentals of credit decision making as well as definitions of different types of collateral used to support authorized credits.



## 5.4 Appendix D: Customer Experience Model

### Receiving

- Be Ready
- Establish Rapport
- Ask how he/she can be of help

### Understanding

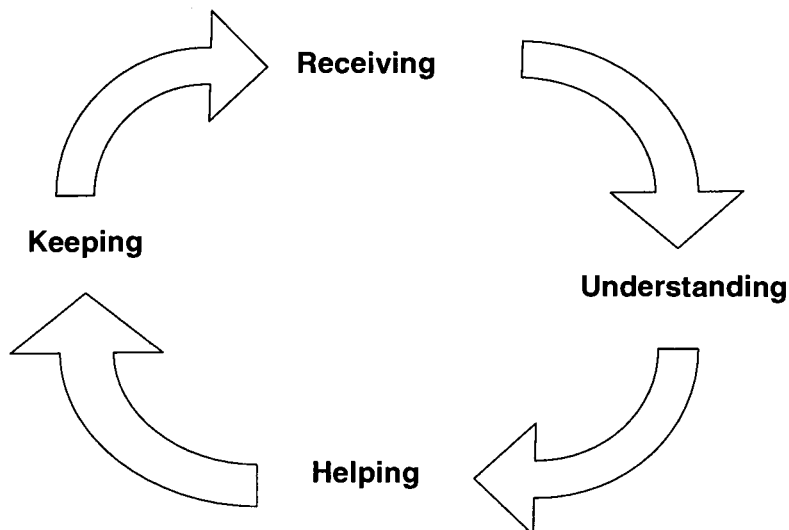
- Explore Initial Need
- Check to Proceed
- Explore Business Profile and Financial Relationship
- Explore Additional Needs
- Summarize and Prioritize

### Helping

- Provide Advice or Recommend Actions
- Obtain Agreement
- Ask for the Business

### Keeping

- Define Next Steps
- Check for Satisfaction
- Express Appreciation



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