Department of Finance Canada

Canada

Retail Debt Program Review Project

Final Report

January 31, 2004

Cap Gemini Ernst & Young

Notice:

Where information has been withheld it has been withheld to protect sensitive third party information, information provided in confidence by another government or to protect the economic interests of Canada.

Contents

Introduction

Canada Savings Bonds have a strong history with Canadians and played a valuable role for government

Canada Savings Bonds have a strong history with Canadians

- The Canada Savings Bond program was launched in 1946 following the popular and valuable Victory Bond campaign.
- The bonds continued to help finance government expenditures while providing Canadians with a savings vehicle valued for its security, cashability and ease of purchase.

The Retail Debt Program has played an important role

- By the 1980s, many Canadians included the offerings as part of their financial portfolio, causing the total pool of outstanding bonds to grow to over $50 billion, or 8.3% of Canadian financial assets.
- Also during this period, savings bonds accounted for 33% of total federal market debt.
- Participation in the payroll program, which also began in 1946, grew to include more than 15,000 employers and 1.5 million employees.

Market pressures challenged the Program

- The 1990s brought increasing competition from financial institutions who invested in product innovation, customer analytics and sales tools.
- Investors gained greater investment sophistication through participation in equity investments and by using channels like the Internet and investment advisors for education on broader options for investments.
- Interest rates declined to the lowest levels seen in a generation, making investors reduce holdings of fixed income investments.

The Retail Debt Program was revitalized in 1996

- The Program was tasked with stopping the decline of the portfolio and maintaining a reasonable and sustainable retail share of total federal debt while ensuring a broad investor base for the government.
- It was also asked to partner with the private sector to offer a family of attractive products benefiting all Canadians, yet consistent with the government's fiscal plan in balancing cost, risk and market considerations.

Introduction (continued)

Despite revitalization efforts, the Program has not been successful in staying relevant with investors

The Program continued to face challenges

- [*Information withheld.*]
- Internet channel investments were implemented to drive a lower cost structure, however interactions through costly telephone channels continued.
- New products were introduced, but remained uncompetitive because they lacked differentiation relative to existing market offerings.

An independent review was required to understand future options

- Currently, the government is undertaking reviews to ensure that government programs continue to be relevant, effective, and valuable to Canadians.
- The government requires an assessment of the past performance of the Program against its objectives, an evaluation of its true future prospects, and the identification of a range of strategic options.

The Program chose Cap Gemini Ernst & Young to provide those options

- CGE&Y has a unique reputation within the Canadian financial services industry for the quality of our retail banking and wealth management expertise.
- We endeavoured to assess the value and viability of the Program, examining the relevance of its product offerings to Canadians and evaluating the efficiency of this source of funds to determine the value of the franchise to government.

This Report identifies strategic options for future consideration

- Our report analyzes Program objectives, value to government, value to investors, current and future environment, organization structure and program design as a way of developing 4 strategic options: Relaunch, Refocus, Basics and Rundown.
- Each option is described in detail and assessed for its implications and financial impact to the Program.

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Executive Summary

Within the context of a changing environment, strategic options are required to address the future viability of the Retail Debt Program

The Retail Debt Program is losing relevancy with Canadians

- The Program has lost importance as a source of funds to government which has seen non-marketable retail debt decline as a share of overall government debt, falling from 7% in 1996 to 5% in 2003.
- The Program has lost importance among Canadians who hold only 1% of total investable assets in savings bonds today compared to 8.3% in 1987.

The Program's future viability is at risk

- The financial services and wealth management marketplace is extremely competitive and investors are displaying increasing sophistication in their investment choices.
- The Program is an expensive source of funds due to the embedded cost of optionality and the impact of its declining stock on per unit cost and administration.

Running down the Program appears to be the best strategic option

- The conclusion of our analysis suggests that running down the portfolio provides the government the greatest savings when compared to the projected cost of the current operations as well as other strategic options.
- In our opinion the Rundown option addresses the key issues related to the value and viability of the Program, when viewed within the context of the current environment.

This Strategic option is supported by comprehensive analysis

- We have assessed the Program's performance to determine the extent to which it met objectives and analyzed the value to government and Canadians within the context of the current and future environment.
- We have also evaluated the impact of choosing this option within the context of the Program's franchise value, a summary of which follows.

Executive Summary

Two components of franchise value existed in 1994 but are no longer applicable

What is *Franchise Value?*

- Franchise value is a term used describe the somewhat intangible value to government that the Program provides beyond its role as financial intermediary bringing together borrower and investor.
- In 1994, it was widely felt that the planned revitalization of the Program would improve two facets of franchise value: enhancing the government's **profile among Canadians** and providing a unique **source of funds to government**.
- On the pages that follow, we reassess franchise value in light of changing environmental forces.

Profile Among Canadians

- The Program offered the government a public relations conduit for delivering positive messages to Canadians through events (i.e., rate changes, product innovation).
- It also provided a mechanism for direct and broad branding of Canada using messages and imagery that resonate with Canadians (e.g., lakes, mountains, fields).
- It presented the government with a great opportunity to disseminate educational savings messages to Canadians.
- The Program offered universal access to a savings product designed as a public good, valued for its security, cashability and ease of purchase – in an environment where financial sector offerings were limited.

Source of Funds to Government

- Facing high debt requirements of a government in deficit and the vagaries of foreign debt holders and currency traders, the Program offered an opportunity to issue bonds to domestic investors.
- In addition, regularly marketing to the Program's bondholders offered the government ready access to a widely distributed network of investors.
- Finally, the Program provided the opportunity for debt to be held by loyal, long term investors less sensitive than institutional players to changes in interest rate fluctuations.

Executive Summary

The Program no longer offers franchise value as an enhancement of government's profile among Canadians

Value and relevance as a public relations tool has diminished

- Modern communication provides government with numerous tools to access Canadians with relevant messages to serve public relations requirements (online, print, television and radio).
- Canadians expect action and results from government on issues such as healthcare, the economy and national security that also present opportunities to enhance the profile of government.

Branding needs are met by others

- The mood of the country has improved since the mid-1990s; Canadians take pride in their culture, value their respect for diversity and cherish their profile on the world stage.
- The analysis revealed that branding of Canada through this Program is perceived as a duplication of the efforts of Canadian corporations and other government departments. As an example, Canadian Heritage spends $1 billion annually on education and promotion of Canadian culture.

Savings habits are targeted by the private sector

- The financial sector has invested heavily in communicating savings and investment messages and in developing a wide array of products and facilities to meet the needs of Canadians experiencing increasing debt loads and diminishing savings.
- The Program's savings messages are viewed as a duplication of the financial sector's efforts and, given the Program's dependency on intermediaries, perceived to be ineffective in following through with relevant offerings that align to key messages.

Market share of investment assets has dropped

- Access to financial sector products and services is ensured because financial services companies are subject to legislation requiring access to banking for all Canadians.
- In addition, protection of deposits held in member financial services companies is guaranteed through the Canadian Deposit Insurance Corporation up to $60,000.
- These changes, combined with the advisory role gaining popularity with an increasingly sophisticated investor base, has resulted in a drop in share of financial assets being captured by the Program from 8% in the 80s to 1% today.

Executive Summary

The Program no longer offers franchise value as a source of funds to government

As a source of funds, the Program is no longer critical

- Today, relative to 1994, we have a government that has created successive budget surpluses, thereby decreasing the overall need for funding.
- Minister Goodale's most recent comment indicated a targeted reduction of debt to 25% of GDP from its current 44%.
- Accordingly, the retail debt has lost importance as a source of funds to government falling from 7.5% of overall government debt to 5% in the last 9 years.

Debt issuance is no longer a challenge

- As Canadian debt as a percentage of GDP fell during the late 1990s, issuing of cost effective debt became less of a challenge.
- Non-resident debt holdings dropped from 28% to 18% over this period, as the government's need for funding decreased.
- The Program provides less value today as a cost effective method of issuing debt.

Access to a broad network of investors is no longer important

- The growth in mutual funds and pension funds of the late 1990s allowed marketable government debt to be redistributed to a retail investor base.
- The effect of this *retail*-ization of wholesale debt on improving the effectiveness of distribution was amplified by the growth in the number of independent and branch-based financial advisors who increased the level of investor sophistication.
- The Program provides less value today in providing a network of ready investors because the network is controlled by intermediaries who are more adept at providing relevant offerings and creating channel loyalty.

Diversity of investors is no longer a concern

- Comparing marketable debt holder behaviour to that of savings bond holders reveals similar interest rate sensitivity today. This is an effect that has been exacerbated during this low interest rate environment.
- In addition, the payroll program's high churn indicates that despite wide participation, this channel's investor base is not holding bonds for the long term.

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CGE&Y's Approach to Analysis

Our analytical approach was comprehensive in order to derive fact based conclusions and strategic options for consideration

We conducted interviews with key stakeholders and other Programs

- We interviewed 12 stakeholders representing internal organizations directly and indirectly involved in the Program as well as 12 external stakeholders who interact with the Program.
- In addition, we interviewed 9 individuals from other retail debt programs operating in the United States, United Kingdom, Sweden, British Columbia and Ontario.

We gathered and consolidated data from a number of sources

- We reviewed over 170 separate documents provided by the Program's working group.
- In addition, we gathered and integrated financial and statistical data from a number of sources within the Program to support our financial and strategic analysis.
- We gathered as much benchmarking data from additional sources as possible.

We conducted primary and secondary research

- We leveraged existing CGE&Y research and analysis of the wealth management and retail banking marketplace to assess the nature of competition within the financial services environment as well as important trends.
- We supplemented our own research with secondary research in the area of investor behaviour and attitudes.

We analyzed financial data and modeled scenarios

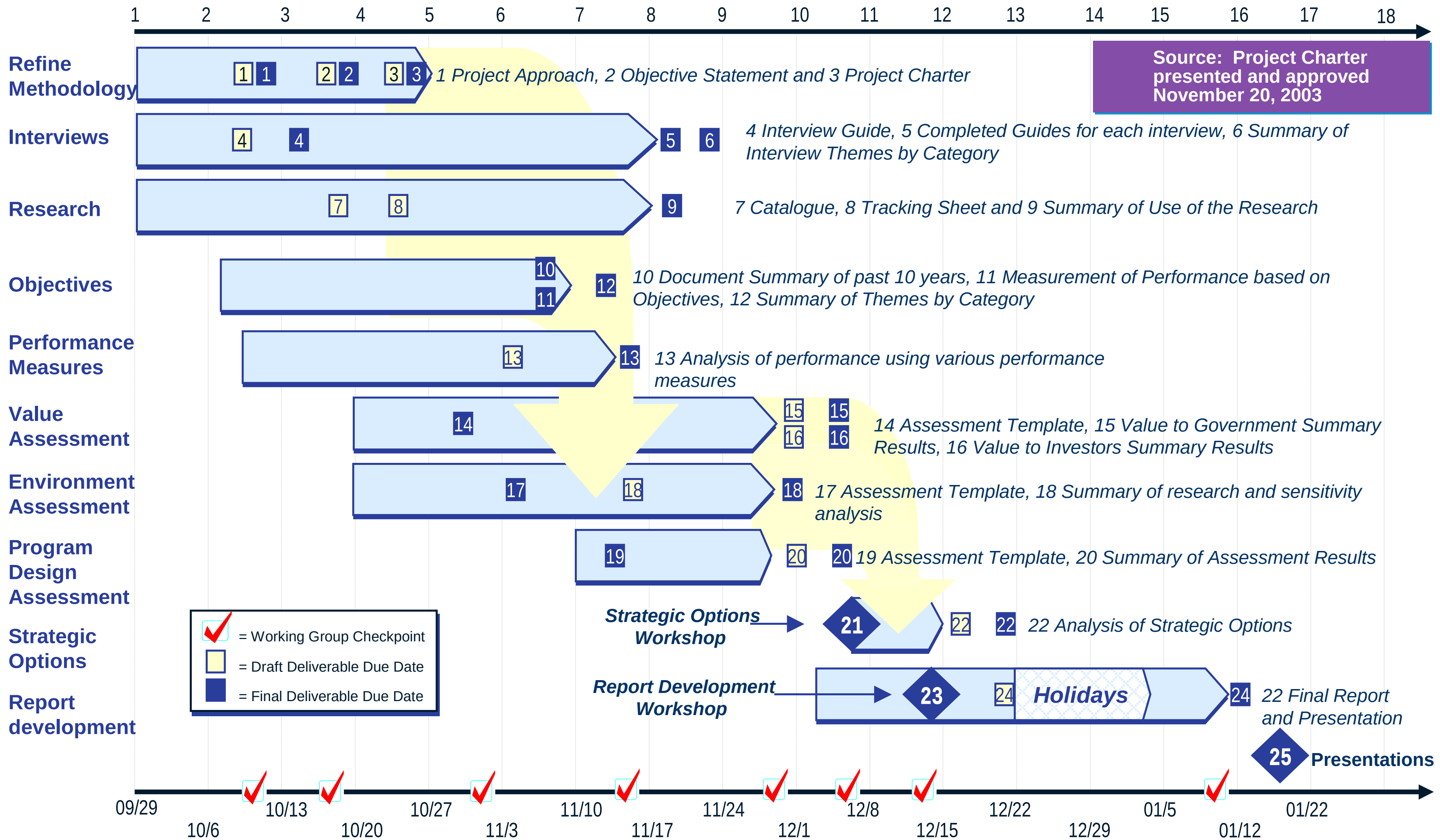
- We employed standard option pricing theory to assess the implied costs of the embedded optionality. This methodology is based on capital markets experience, and was validated as an appropriate methodology by the working group.
- We gained insight into cost drivers and performance measures using financial modeling, once data had been consolidated from a number of sources.

We integrated research and analysis into four strategic options

- We analyzed the results of our research and integrated these within the context of emerging industry and government forces to derive a set of approximately eight strategic options.
- We reduced this initial set to a final four using financial modeling and projections based on changing over a dozen underlying assumptions.
- We provide detailed descriptions that include implications, pros, cons, financial estimates, issues and considerations to support our verdict and to communicate our findings.

CGE&Y's Approach to Delivery

Our project approach enabled integration of analysis while keeping the Program's working group regularly updated



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Overview of Strategic Options

Based on our assessment of the Program's value and viability, CGE&Y identified four options for consideration

1. Relaunch

Objectives: **Grow** the retail non-marketable debt portfolio and **encourage savings** in partnership with other entities, building the franchise of the Program as both a source of funds and as a vehicle to increase the government's profile with Canadians.

- Grow the portfolio through innovative products, competitive returns and commissions in addition to current products.
- Partner with channels and other organizations to promote savings as a behaviour.

2. Refocus the Status Quo

Objective: **Improve cost effectiveness** of the Status Quo, maintaining the franchise of the Program as both a source of funds and as a vehicle to increase the government's profile with Canadians through its product.

- Rationalize by leveraging the CPB in the sales agent and direct channels, and the CSB in Payroll.
- The social objective of promoting savings is left to the private sector to address and the Branding to other government departments and Canadian corporations.

3. Basics

Objective: Deliver a basic product through the most cost effective business model, **maintaining a very minimal franchise** as both a future source of funds and a vehicle to maintaining a profile with Canadians.

- Price the product (CPB only) to be cost effective, inclusive of optionality.
- Reduce the infrastructure to a minimum.

4. Rundown

Objective: **Rundown the Program** in the most cost effective manner possible while maintaining a satisfactory level of service with existing investors. This option is based on the absence of significant Franchise value of the Program as both a future source of funds and a vehicle to maintaining a profile with Canadians.

- No new issues, no new products, no new payroll enrollments, no marketing.
- Continue service and support to existing bondholders.

1. Relaunch *Realign to promote savings behaviour in Canadians through the launch of innovative products with competitive returns*

Premise

- The objective is to grow the retail non-marketable debt portfolio and encourage savings in partnership with other agencies by building the franchise of the Program as both a source of funds and a vehicle to increase government's profile with Canadians.
- This option positions the program in direct competition with FIs, using competitive products, messages and pricing.
- The goal is delivering financial and social value to investors, without as much concern for cost effectiveness; specifically:
  - Increase stock to 7% of federal debt (example)
  - Develop a portfolio of products that are relevant and competitive in the marketplace.
  - Craft partnerships (internal and external to government) that will increase the effectiveness of the savings message while reducing the investment necessary.
  - Begin with existing CSB, CPB and add new products.

Other RDP Lessons

- The UK Retail Debt Program has a strong emphasis on product innovation, branding and direct competition with FIs within a primary objective of cost effectiveness.
- Unlike the UK program, the *Relaunch Option* ties its objective to the social value of savings behaviour which is more aligned to the US program goals.
- Both UK and Sweden offer competitive savings accounts in direct competition with the private sector and have avoided enduring or open criticism.
- US program issues 'bills and bonds', but there is concern that this serves the wealthy rather than the underserved. Further, it only represents 1-2% of the program's sales volume indicating that the return on the investment in the systems for 'bills and bonds' distribution is very low.
- Sweden is in the early stages of a 'bonds for all' program offered through direct channels as an attempt to integrate all retail offerings.
- Ontario has competitive pricing [*Information withheld*] combined with enticing commissions and excellent relationships with channels.

Stakeholder Views

- Interviewees identified the security of the bonds as the Program's main value.
- Stakeholders were split between those who saw the government in a unique position to offer innovation and those who pointed to the mass market of unsophisticated investors for whom the Program should provide simple products only.
- A large proportion of interviewees suggested that the marketplace already offers ample mechanisms for encouraging savings, even in a tax advantaged manner (i.e., registered products, dividends, capital gains, real estate) and that the Program is not properly positioned to follow through on this message given its dependence on intermediaries to sell its products.

Implications

Program Efficiency and Effectiveness
- The Relaunch Option is cost *in*effective given the investment required to develop and price products competitively.
- There are high costs associated with sophisticated products such as hedging costs, foregone tax revenues as well as the infrastructure necessary to originate and service.
- Social policy KPIs have to be developed in order to plan and measure the objectives from a social benefit perspective.

Program Design
- Innovate products to align to the social purpose of this option, including alternatives such as tax-advantaged, inflation-indexed and matching programs.
- Leverage technology investments through enhanced direct channel functions by offering other retail debt (bills, bonds) through the Internet to all Canadians.
- Reduce redemptions through better products, shorter sales period and more effective tools for origination and service.

Stewardship and Organization
- Stewardship of the program must be unified under one entity to allow more nimble reactions to the marketplace.
- Define reporting standards and KPIs; formalized in a new MOU.
- Report on financial performance as well as success in meeting social mandate, including financial statements.

Environmental Impact
- This option prompts an increase in sales through all channels since investors – aided by investment advisors – seek the highest net returns they can find in the market.
- This option would also create a backlash from FIs who develop competing products, thereby enhancing value to investors at the expense of FI margins and cost effectiveness to government.

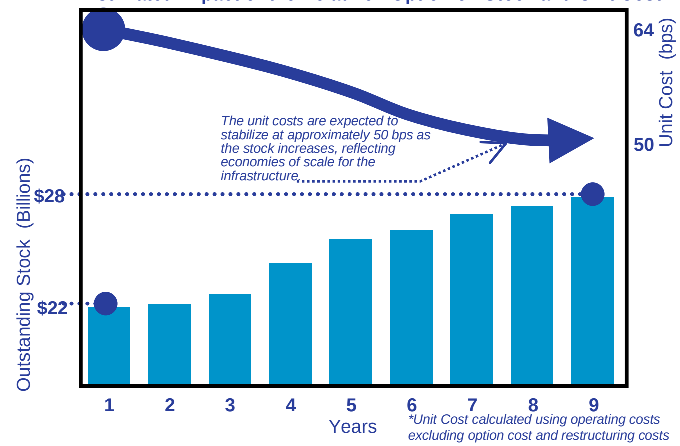
Pros

- ✓ Visibility of program in the eyes of Canadians
- ✓ Direct access to savings products by Canadians
- ✓ Enhances the role of government in personal finances and positions access to the 'best products'
- ✓ Renews the Program as a platform for government to deliver savings and other positive messages to Canadians

Cons

- X Costly program given complexity of products design and delivery combined with the investment in technology required
- X Sophisticated products will be perceived to benefit the more wealthy at the cost of taxpayers
- X Poor value for money for Canadians as most investors will still look to other means to satisfy their investment needs
- X Public backlash due to misalignment with values of fiscal prudence and current priorities of Canadians
- X Industry backlash due to public sector 'crowding out': competition would further restrict access to customers, government would be reluctant to take on the private sector
- X The organization will continue to have difficulty being as nimble as FIs given that pricing will still need to be reviewed by others

Estimated Impact of the Relaunch Option on Stock and Unit Cost*



**Unit Cost calculated using operating costs excluding option cost and restructuring costs*

Issues

- FI reaction to bold competitive positioning will result in continuing difficulty selling through the sales agent channel and lack of sponsorship in disseminating savings messages.
- The FIs and the dealers will continue to own the customer relationship.
- Effectiveness of commissions to drive channels to sell.
- Sensitivity of investors to pricing will determine the impact on the sales.
- High cost of the embedded option when pricing the products to be competitive.
- There are no known safeguards against *undersaving* segments continuing to be ignored and affluent *oversaving* segments taking advantage of government subsidized returns.
- The one month pricing will continue to restrict the ability of the Program to be nimble and will provide the FIs with an opportunity to sell their own products.

Considerations

- Confirm the role of non-marketable retail debt within the portfolio of federal debt in the current environment.
- Assess the appetite of government to create products that provide tax benefits.
- Define the subsidy that the government is willing to invest in the Program.
- Conduct a detailed budget review, for example:
  - Conduct research to identify most relevant products
  - Quantify the cost of any contract terminations
  - Assess the cost of renegotiating the EDS agreement *if necessary*
  - Conduct a skills assessment for the team including those skill sets required to manage a more complex portfolio (hedging, etc.)
- Develop a new MOU based on new organization structure and mandate.

Verdict

- We assessed the value of the Franchise (see Value to Government section) and conclude that in today's environment, the cost of maintaining this program outweighs the benefits.
- We conclude that this option, which aims at growing this source of funds as well as the social aspects of the program at a cost of more than $1.2B over 9 years (excluding restructuring and embedded option costs) is misaligned to the government's and Canadians' values of fiscal prudence.
- We therefore recommend against the Relaunch Option.

2. Refocus the Status Quo *Target initiatives to improve cost effectiveness in all operations, including product development, origination and servicing*

Premise

- The objective is to improve cost effectiveness of a modified status quo, maintaining the franchise of the Program as both a source of funds and a vehicle to increase government's profile with Canadians through its product.
- The Program would operate within strict cost boundaries and price products using acceptable industry methods as approved by the Finance Department.
- The rate equals the wholesale rate less administrative costs and option cost; plus a small subsidy of 20% (e.g.) necessary to maintain market share of the value subsidized.
- The Program maintains unit cost between 45 and 50 bps.
- It offers CPB in sales agent channel; CSB in Payroll.
- The social objective of promoting savings is left to the private sector to address.

Other RDP Lessons

- US program demonstrates success in eliminating its marketing efforts and satellite offices and relying solely on existing, residual brand awareness.
- In the US, FIs still view selling savings bonds as part of their mandate as corporate citizens, creating a more collaborative and less competitive environment.
- The US program emphasizes online sales, but at 0.5% of sales currently, admits that it will likely take a long time (more than 5 years) to convert to the Internet due to slow investor take up. In the meantime, high systems costs will continue.
- There is an inherent subsidy in the US program since their cost effectiveness model does not measure against wholesale debt.
- The cost of the program is also not publically disclosed and the model once used to calculate the cost effectiveness has been rejected by Congress as incomplete.
- Sweden withdrew its tax advantaged bond offering after observing that is did not prompt a change in savings behaviour.
- UK is currently reviewing its portfolio of offerings to ensure that product features are cost effective and competitively priced given investment thresholds.
- Ontario Savings Bonds do not pay trailers but pay commissions up front, a practice it has found to be successful. The program is popular with FIs and investment dealers due to higher returns on products. [*Information withheld*]

Stakeholder Views

- Interviewees identified elongation of the sales period and new product enhancements as unnecessary irritants to the sales agent channel. Another source of irritation was changes to commission structures.
- Marketing was criticized by stakeholders for being ineffective and untargeted given entrenched awareness of both brand and timing;
- Interviewees also criticized spending on 'branding Canada' as something that is already being done by the government and Canadian companies.

Implications

Program Efficiency and Effectiveness

- Reverting to a condensed sales period, reducing marketing to simple campaign messages and reducing the exposure to market rate fluctuations that FIs can adapt to more quickly.
- Eliminating the savings message and branding objectives.
- Commissions must be aligned to market, removing trailers.
- Negotiate payouts with FIs for trailers on old series that account for $89M over the 9 year period.
- Standardize processes and manage strictly to those processes to significantly reduce the number of exceptions.

Program Design

- Simplify the payroll program to a CSB product originated and serviced only through the Internet.
- Offer the CPB product in the Sales Agent channel and direct channels, with strict redemption conditions.
- Rationalize marketing by ceasing TV advertising and limiting the frequency of print ads consistent with the shorter sales period.
- Implement user fees to recover costs for gift cards, certificates, lost bonds, transfers, exchanges and registration.

Stewardship and Organization

- Rationalize organization within the Bank of Canada. The Bank's team has the knowledge to reduce the costs and continue managing the EDS contract and program within a more focused framework. Any missing competencies can be outsourced as appropriate.
- Define reporting standards and KPIs and formalize in a new MOU.
- Report on financial performance, including financial statements.

Environmental Impact

- This option is unlikely to elicit significant feedback from the public due to entrenched seasonality of the bond campaign.
- A shorter campaign and streamlined offering will prompt neutral – and potentially positive – feedback from the FIs and dealers.
- Positioning the Internet as a mandatory channel for payroll will not surprise many Canadian savers.

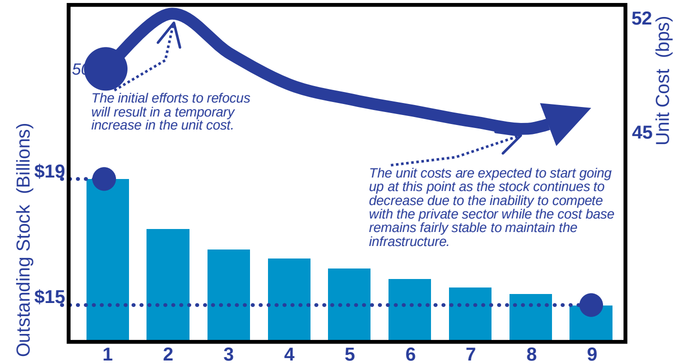
Pros

- ✓ Continues to provide Canadians alternatives for basic savings and investment needs.
- ✓ Maintains franchise for future funding requirements.
- ✓ Minimizes negative reaction from the public.
- ✓ Viewed as partially aligning to fiscal responsibility through transparent reporting of targets and results including the subsidy.

Cons

- X Canadians likely to perceive this program as not being aligned to current priorities of healthcare and fiscal prudence.
- X Risk that cost will be difficult to contain despite best efforts.
- X Disregards the results of the analysis that the payroll program finances periodic purchases of participants which is misaligned with the objectives of saving for the long term.
- X FIs would be unreceptive to this option since it continues to provide competition in an already highly competitive environment.

Estimated Impact of the Refocus Option on Stock and Unit Cost*



**Unit Cost calculated using operating costs excluding option cost and restructuring costs*

Issues

- With the limits on the subsidization through unit cost and option cost, there is a risk that the pricing will not be sufficiently attractive to investors and will give the FIs sufficient room to better the GIC rate through relationship pricing.
- Program likely to encounter potential negative investor reaction to user fees for what is considered a government sponsored program.
- A subsidy remains to fund a program that has an impact on a limited amount of Canadians and does not align with current priorities such as healthcare.

Considerations

- Confirm the role of non-marketable retail debt within the portfolio of federal debt in the current environment.
- Determine the public policy objectives, if any, that must served by the Program.
- Define the subsidy that the government is willing to invest in the Program.
- Conduct a detailed budget review, for example:
  - Validate that payroll is only moderately sensitive to user fees
  - Validate that, through actions taken, the churn of payroll will reduce to levels similar to the sales agent channel
  - Validate the projected redemption pattern
  - Quantify the cost of contract terminations
    - Assess the cost of renegotiating the EDS agreement until the exit
- Develop a new MOU based on structure and mandate.

Verdict

- We assessed the value of the Franchise (see Value to Government section) and conclude that in today's environment, the cost of maintaining this program outweighs the benefits.
- We conclude that this option, which costs more than $700M over 9 years (excluding restructuring and embedded option costs) is misaligned to the government's and Canadians' values of fiscal prudence. This conclusion is drawn despite the objective of maintaining this source of funds and providing a public good to maintain a profile with Canadians.
- Our analysis shows that subsidization of the products has had no impact in reversing the decline in bond stocks. Further that the payroll program subsidizes the periodic purchases members and therefore is misaligned with the objective of helping Canadians save for the long term.
- We therefore recommend against the Refocus Option.

3. Basics *Streamline to target the core segment with a simple and basic product through the most cost effective model*

Premise

- The objective is to deliver a basic product through the most cost effective business model, maintaining a very minimal franchise as both a future source of funds and a vehicle to maintaining a profile with Canadians.
- The *Basics Option* is based on the premise that the Program has franchise value to government but needs to focus on the operating cost effectively above all other objectives.
- The Program would operate within strict cost boundaries and price its products for the program cost effectively, using acceptable industry methods with no subsidy for the option cost.
- The rate equals the wholesale rate less administrative costs and option cost. It would maintain unit cost between 40 and 50 bps.
- It offers CPBs in the sales agent channel using current processes and existing technology; further investments are eliminated.
- Promoting savings is left for the private sector to address.

Other RDP Lessons

- The Ontario Savings bond limits redemptions to anniversary dates, offers simple and high rate products with a short sales period and upfront and competitive commission structure which has proven to be successful.
  - [*Information withheld*]
- The US program has described their main customer base as similar to Canada's: the elderly who are best served with more simple products. Their marketing focuses solely on basic investor education aligned to the products offered. Their small Internet channel adoption identifies that the sales agent channel remaining the prevalent one for this customer segment.
- Sweden offers very simple products, one aimed at the wealthy and one aimed at the less affluent.
- The UK is reviewing its portfolio of offerings to ensure each product's features are cost effective relative to wholesale.

Stakeholder Views

- Stakeholders pointed to the payroll program as a costly offering that could be substituted by a number of savings account offerings in the marketplace (i.e., ING, PCF, mutual funds).
- Interviewees identified elongation of the sales period and new product enhancements as unnecessary irritants to the sales agent channel.
- Marketing was criticized by stakeholders for being ineffective, unnecessary and untargeted given entrenched awareness of both brand and timing. The 'branding of Canada' was also rejected by most as being a duplication of the efforts of Canadian companies and other departments.
- Social value was discounted by interviewees, who cited the many other organizations that focus on the savings message within the government as well as externally.
- Other social programs such as healthcare were seen as being in need of funds to serve a greater purpose.

Implications

Cost Effectiveness and Efficiency

- Leverage current processes, relationships and Bank of Canada team to continue operations within the sales agent channel.
- This option requires no investment in technology, process or knowledge transfer.
- Achieve cost effectiveness by reverting to a condensed sales period reducing marketing to simple campaign messages and reducing costs related to future redemptions with user fees and a product that motivates investors to save for the long term (CPB).
- The shorter sales period will limit exposure to fluctuating rates.
- Commissions must be aligned to the market by removing trailers.
- Negotiate with FIs for payouts trailers on old series bonds; otherwise the Program faces $89M over the 9 year period.

Program Design

- Eliminate the payroll program.
- Eliminate sales by phone to reduce costs.
- Maintain direct channels with no investment in innovation or new systems given the existing processes and infrastructure and recover costs through user fees where appropriate.
- Rationalize marketing by ceasing TV advertising in favour of inexpensive print or radio advertising, limit the frequency in line with the shorter sales period.
- Implement user fees to recover costs for gift cards, certificates, lost bonds, transfers, exchanges and registration.

Stewardship and Organization

- Rationalize organization within the Bank of Canada. The Bank team has the knowledge to reduce the costs and continue managing the EDS contract and program within a strict framework.
- Define reporting standards and KPIs and formalize in a new MOU.
- Report on financial performance, including financial statements.

Environmental Impact

- This option will elicit feedback from the public in reaction to the elimination of the payroll program and the CSB.

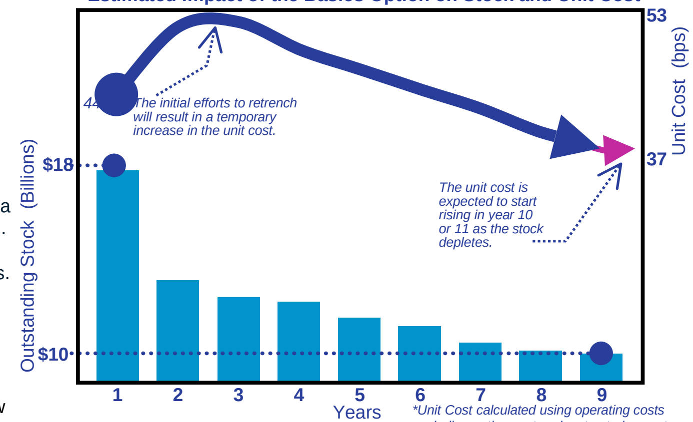
Pros

- ✓ Maintains franchise for future funding requirements should the need arise.
- ✓ Viewed as aligning to fiscal responsibility through a cost effective program while still fulfilling a social need for a focused segment of the population.
- ✓ Continues to provide Canadians, likely the aging segment of the population, with a basic, simple and secure alternative for their savings needs.

Cons

- X This risks being interpreted as a windup of the program, temporarily hidden behind an objective of fiscal responsibility.
- X The sophistication and competitive nature of the FI sector in Canada provides better investment alternatives for investors.
- X Stock will continue to fall, which will make the cost effectiveness objective difficult to accomplish, especially in the longer term.
- X Within the context of the competitive wealth management

Estimated Impact of the Basics Option on Stock and Unit Cost*



*Unit Cost calculated using operating costs excluding option cost and restructuring costs

Issues

- Potential negative investor reaction to user fees for what is considered a government sponsored program.
- It is difficult to confirm the reaction and willingness of the industry to support and collaborate as it did in the past, in support of this option, and it is expected that the market would likely be unreceptive to a Basics program.
- Our analysis has indicated that the cost of running this program will be difficult to contain, even when imposing cost reduction measures.
- Fixed costs will eventually prevent the unit cost from decreasing further, indicating a wind-up of the program we estimate as being between years 10-12.

Considerations

- Confirm the role of non-marketable retail debt within the portfolio of federal debt in the current environment.
- Determine the public policy objectives, if any, that must served by the Program.
- Conduct a detailed budget review, for example:
  - Quantify the cost of contract terminations
  - Assess the cost of renegotiating the EDS agreement for the Basics Option
  - Develop new MOU based on structure and mandate
- Establish the life of the Program and shorten the maturities of the products to wind the Program down in a timely manner.

Verdict

- We assessed the value of the Franchise (see Value to Government section) and conclude that in today's environment, the cost of maintaining this program outweighs the benefits.
- We conclude that this option, which costs more than $500M over 9 years (excluding restructuring) is misaligned to the government's and Canadians' values of fiscal prudence. This conclusion is drawn despite the objective of maintaining this source of funds and providing a public good to maintain a profile with Canadians.
- We recommend against the Basics Option because the financial sector already provides necessary tools for investors to save for the short and long term. Government's priorities of further reducing the debt in the long term and focusing on the priorities of Canadians, namely healthcare, underscore the misalignment between this option and the government's own priorities.

4. Rundown *Wind up the Program by running down the stock using minimal infrastructure, continuing to provide service and support to existing bondholders*

Premise

- The objective is to reduce by attrition the program's portfolio in the most cost effective manner possible, while maintaining a satisfactory level of service for existing bondholders. This option is based on the assessment that franchise value no longer exists because the Program no longer promises a future source of funds or a vehicle for maintaining a profile with Canadians.
- The *Rundown Option* is based on a premise that the Program is unsustainable and costing government and Canadians more than it provides.
- Rather than simply exiting the market, however, some grandfathering of existing relationships should occur in order to ease transition of investors to other options.
- The objective is to reduce the costs to a minimum operating and infrastructure base to rundown the stock without future sales.

Other RDP Lessons

- BC ran down its program and did not experience backlash from the public, [*Information withheld*]
  - The minister responsible argued that having 'liquidity insurance' in the face of capital markets volatility was an insufficient reason to maintain a cost ineffective program. He argued that with 6 weeks notice, and selling through the dealer network only, they would have access to this alternative source given a competitive price.
- UK and US programs operate programs on a tighter budget while maintaining their sales and stock at reasonable levels. However, the context of each program is very different which needs to be considered when contemplating application of lessons learned.
  - UK and Sweden operate in a less competitive environment which directs more investors toward government products.
  - US operates in a regulated environment where the returns on their offerings are very competitive with the FI sector. In addition, the patriotism of the population and of the channels in selling the offerings is very different from the Canadian environment.

Stakeholder Views

- Stakeholders pointed to the lack of cost effectiveness as the main reason to cease operating the program, indicating that taxpayers should not bear the cost of a program targeted to such a small segment of the population.
- A large proportion of interviewees suggested that the marketplace already offers many mechanisms for encouraging savings, even in a tax advantaged manner
- Conversely, certain stakeholders admitted that the program is perceived as providing a social benefit (encouraging savings).
- Stakeholders stated that CDIC insurance is a valid and sufficient means of providing security to investors.
- Social value was discounted given that there are many other organizations that focus on the savings message.
- Other social programs such as healthcare were seen as being in need of funds to serve a greater purpose.

Implications

Cost Effectiveness and Efficiency
- Gain cost effectiveness in reducing resources dedicated to product and channel activities, marketing and sales.
- Encourage bondholders to utilize self-serve channels to reduce service requirements.
- As the option is implemented, reduce the infrastructure to a minimum to maintain basic servicing for existing investors.
- Negotiate with FIs for payouts trailers on old series bonds; otherwise the Program faces $89M over the 9 year period.

Program Design
- Payroll program runs down through attrition; combined with user fees to cover transaction costs.
- Web channel and sales agents take priority for service and support.

Stewardship and Organization
- Rationalize organization within the Bank of Canada. The Bank's team has the knowledge to reduce the costs and continue managing the EDS contract and program within a strict framework.
- Define reporting standards and formalize a new MOU.
- Report on financial performance, including financial statements.

Environmental Impact
- Canadians will understand the decision to rundown, within the context of fiscal restraint and accountability.
- FIs and industry stakeholders would welcome the rundown as a natural conclusion to a program that from their perspective has outlived its purpose.
- New savings from investors would find a home in the many other products that make up the 99% of investable assets in the private sector or within the wholesale market for wealthy investors.

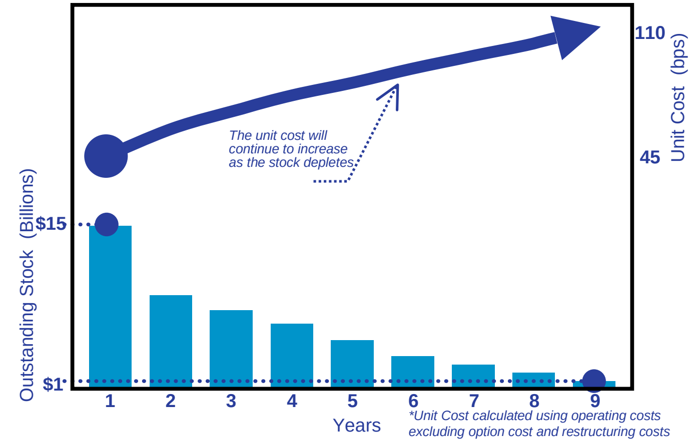
Pros

✓ Moves the program towards cost effectiveness immediately by reducing high cost items: sales commissions and marketing.
✓ Maintains a reduced franchise as a source of funds should the need arise to use the remaining infrastructure necessary to rundown the program over the remaining life of the bonds.
✓ Maintains a level of support for loyal bondholders while aligning to fiscal responsibility values.
✓ Restricts investment in the Program so funding can be redirected toward other priorities.
✓ This option aligns to the competitive environment that has evolved to include the widespread availability of numerous similar products.

Cons

X Time consuming process could last until 2013 requiring management effort.
X [*Information withheld*]
X Loss of franchise that provides a vehicle to maintain a profile with Canadians for the government.

Estimated Impact of the Rundown Option on Stock and Unit Cost*



Issues

- Social responsibility to transition aging population to new investments.
- Fixed costs prevent the unit cost from decreasing further.
- This option will terminate a Program that has been viewed as either a government or employer benefit by many which is likely to have a significant, negative public relations impact.

Considerations

- Confirm the role of non-marketable retail debt within the portfolio of federal debt in the current environment.
- Determine the public policy objectives, if any, that must served by the Program.
- Conduct a detailed budget review, for example:
  - Validate the projected redemption pattern
  - Quantify the cost of contract terminations
  - Assess the cost of renegotiating the EDS agreement until the exit
- Develop a new MOU based on structure and mandate.
- Define a clear message that will convey the rationale behind the decision to rundown the program and the options available to Canadians.

Verdict

- We assessed the value of the Franchise (see Value to Government section) and conclude that in today's environment, the cost of maintaining this program outweighs the benefits.
- Our analysis suggests the program is unsustainable in its current structure and faces a difficult environment for sales in the future.
- The Program's cost structure is high in comparison with the cost of running similar portfolios in the private sector given its low volumes and its product features which are surpassed by the private sector.
- The sophistication of the FI sector and competitive nature of this industry points to better investment alternatives in the future, complemented by advisory services, for investors.
- Based on the analysis, our suggested course of action is the Rundown option that will help the government focus on fiscal responsibility and other prioritized social programs.
- The estimated cost is approximately $350M over the next 9 years, excluding restructuring costs.

Assumptions *We used these parameters to estimate the financial impact of the Strategic Options*

	1. Relaunch	2. Refocus	3. Basics	4. Rundown
Market Share	1996 goal equivalent was to reach 3% market share, translating to 7% of federal debt.	Gradual decline, stabilizing over time.	The market share will decline and stabilize to the natural, core customer base of the program and continue to decline over time given the dynamics of this segment.	Decrease to zero over time.
Stock	Increase to 7% of the debt (currently at approximately 5%) to be reached in year 10. 7% of federal debt is estimated at $31B.	Decrease that will stabilize over time due to user fees that aims at recovering costs and lowering the redemption rates.	Natural decline of the stock over time as the redemptions of the old series and the maturities exceed the sales on a consistent basis.	Decrease to a small balance over time. It is expected that a small balance will remain indefinitely (e.g. War Bonds)
Sales	Increase the sales to *(e.g.)* $5B to exceed the maturities & redemptions by $1B per year to rebuild the stock.	Sales will decrease and then stabilize. Payroll at *(e.g.)* 50%, Sales Agents at *(e.g.)* 80% decreasing to *(e.g.)* 65% over time.	Sales to decrease at a natural rate.	No new sales or series.
Payroll	Expand the offer, increase enrolments, convert to web enabled process (self service, no paper statements, redemptions on web), standardize process.	Streamline program, CSB only, keep enrolment stable: Move to web enabled process (incl. redemptions), standardize process, recover costs through user fees.	Close the program at end of current series; No new sales. Redemptions and service only through the FIs.	Close the program at the end current series; Redemptions and service only through the FIs.
Sales Agents	Cultivate relationships with sales agents, set competitive price & commissions, shorten campaign duration in response to their concerns.	Maintain this channel, CPB only; tighten campaign to shorter time frame, implement user fees for gift cards, certificates, lost bonds, transfers and exchanges.	Eliminate phone sales, shorten the campaign duration. Recover costs of transactions; gifting cards, certificates, lost bonds, exchanges & transfers through user fees.	No sales; redemptions and service only
Direct	All products: Build and expand portal to include FIs, investors and employers with more complete purchasing, servicing and redemption functionality	Leverage existing Portal for CPB only. Augment the functionality based on case by case basis, supported by quantified business cases: FI portal funded by FIs, etc.	No innovation. Maintain current infrastructure and leverage existing functionality for the web only. Recover costs through user fees.	Service and redemptions only
Product Mix	To include more sophisticated products to reach a wider spectrum of investors *(e.g.)* inflation indexed, equity linked, bills and bonds direct, etc.	CSB in the payroll channel with user fees, CPB in the sales agent and direct channels with redemption on anniversary date and competitive rate.	Back to Basics: Simple and Safe. CPB only, redemption on anniversary date only. Rename to maintain brand recognition in "Savings Bond".	No sales
Marketing	Increase partnership with other organizations or departments to communicate savings message; refocus marketing message around new products & acquisition	Restrict to print: Printing & distribution remains stable, research remains stable, PR increases by *(e.g.)* 25%, Advertising and creative decrease *by (e.g.) 50%.*	Restrict to print: Printing & distribution remains stable, research goes down *(e.g.)* 75%, PR increases by *(e.g.)* 50%, Advertising and creative decrease by *(e.g.)* 50%	Web info only Public relations cost to rise by 100% and hold steady as required.
Commissions	Increase commissions by 25% *(e.g.)*, paid up front or in line with market trends. Provide incentive for the sales force to convert payroll to web enabled payroll program.	Align model to industry practice,, i.e. remove trailers.	Align model to industry practice, ie. remove trailers.	No sales, only trailers and redemption fees on old series.
Payroll Sales Force	Increase in salesforce of 25% *(e.g.)*. Drive enrolment and focus on conversion to the web enabled Payroll Program	Reduce salesforce by 25%. Lower salary and higher bonus based on conversion of payroll to ePayroll Program.	Manage the transition to close the payroll program.	Manage the transition to close the payroll program.
EDS	VC: n/a FC: Stable Innovation: Increase due to significant investments	VC: Cost recovery through user fees *(e.g.)* 25% of VC FC: Stable Innovation: Moderate increase due to investments	VC: Cost recovery through user fees *(e.g.)* 50% of VC FC: Stable Innovation: None	VC: Renegotiate, *(e.g.) [Information withheld]* FC: Renegotiate, *(e.g.) [Information withheld]* Innovation: None
DAO function	Certain functions would be integrated in the new entity. Assumption is for approximately 50% of the costs to remain. Policy advice function to remain.	Keep stable in order to enable integration of Program into the Bank of Canada. Policy advice function to remain.	Reduce contract management by 25%. Policy advice function to remain.	Reduce contract management by 50%. Policy advice function to remain.
Organization	Centralize in an entity with clear responsibility and accountability, targets, reporting standards & MOU. Enforce education message & build FI, IDA relationships.	Refocus into single entity within Bank of Canada with clear responsibility and accountability, targets and reporting standards. Outsource functions as required.	Integrate in the Bank of Canada with clear responsibility and accountability, targets and reporting standards. Certain agency functions to be integrated.	Integrate in the Bank of Canada with clear responsibility and accountability, targets for the rundown & reporting standards.
Overall Program Cost	Unit cost will increase with introduction of new and more costly products and the investment necessary to relaunch. Subsidize up to the full cost of the embedded optionality, warranting disclosure & transparency. -------------- Administration costs will be in excess of $1.2B for a 9 year period *(excluding the costs of the option, the introduction of new products and the restructuring)*	Unit cost expected to decrease and stabilize in the range of 45-50 bps excluding cost of option. Investment required to refocus. In addition, subsidize up 20% of the embedded optionality, warranting disclosure & transparency -------------- Administrative costs will be in excess of $700M for a 9 year period *(excluding costs of the option and restructuring)*	Unit cost expected to decrease and stabilize in the range of 40-50 bps. Primary objective is cost effectiveness, therefore no subsidy to the value of embedded optionality to be provided. Reduce infrastructure to a minimum to deliver to the core client. -------------- Administrative costs will be approximately $500M for a 9 year period *(excluding restructuring costs)*	The unit cost is expected to be higher until exit. Inherent subsidy as infrastructure maintained for 9 years for service and support. -------------- Administrative costs will be approximately $350M for a 9 year period *(excluding restructuring costs)*

Contents

Overview of the Supporting Analysis

We answered key questions to assess Program value and viability as we developed and analyzed strategic options

Objectives	Value to Government	Value to Investors	Environment	Organization	Design
• Was the Program effective in setting objectives and performance measure? • Did the Program meet its objectives and performance measures?	• Does the Program provide value to government?	• Does the Program provide value to investors when compared to other savings and investment offerings?	• How has the market environment affected the Program's performance? • What are the future prospects for the Program?	• How does the Program's organizational structure enable effective delivery of its offerings?	• How viable is the Program's current design? • How effective is product development, origination and servicing?

Objectives

Was the Program effective in setting its objectives and did it meet its objectives?

We used a fact based approach to assess the objectives

- We reviewed Program documentation from 1995 to 2003 to categorize and analyze both the objective setting process and results.
- We linked the objectives assessment to the analysis of performance measurements, the case studies of other programs and our interviews of internal stakeholders to develop an overall evaluation of Program performance.

Objective setting processes were ineffective in providing guidance

- The responsibility and accountability for the objective setting process was unclear.
- The process was cumbersome and lengthy given the lack of consensus on the priorities of the Program within internal stakeholder groups.
- The objectives were adapted to the federal debt situation and other influences such as the Auditor General's report, but show a departure from quantifiable objectives, and include conflicting themes such as entrepreneurialism, innovation, branding and cost effectiveness which are not prioritized.

We observed a lack of discipline in the monitoring of the Program

- A review of the Program was not conducted by its fifth year of operations, as dictated by the Agency's charter document.
- The set of performance measures did not facilitate measurement against objectives and was not updated to monitor and report on performance in a timely and consistent manner.
- The business plans and financial statements do not provide stakeholders with sufficient information to understand the objectives, performance or overall subsidy provided by government.

The Program was not effective in consistently meeting objectives

- The reduction in costs over the past 10 years was offset by a declining stock on a fixed cost base.
- The Program did not maintain its sales (from $5B to $3B), market share (from 2.5% to 1%) or share of Federal debt (from 7% to 5%) during the period 1996 to 2003. While this may be appropriate in the context of the decreasing federal debt portfolio, the mandate for the Program was not clearly redefined and documented to articulate this change in environment or context.
- The Program has achieved some of its objectives by introducing two additional products, achieving high service levels, outsourcing costly processes and promoting a strong Canadian brand.
- We recommend a more rigorous approach to objectives setting and a revision of business goals aligned with the overall government debt strategy, under any of the strategic options.

We found the documented objectives to be broad and unquantified leading to challenges in planning, execution and measurement

Suitable
Tactical
High Level
Contradictory

	Provide Effective Funding	Maintain Investor Base	Fulfill Market Needs
1996: Official Launch – Finance Minister Martin	**Contributing to the overall debt strategy by:** "…reducing our reliance on foreign investors, and our vulnerability to the sudden shifts on volatile money markets."	**Maintain the relative stock:** "to regain a reasonable share of that lost ground in the retail debt sector…to stop the decline in CSB sales, to hold on to the 3-per-cent share of market we still have."	**Complement the partners of the programs:** "…the new products we will launch over time - as being complementary to the offerings from the private sector. We are looking at unique offerings that can fill un-met needs in the Canadian savings environment. We want to help expand the savings market - something that can ultimately benefit us all: individual savers, financial institutions , and the government."
Initial Charter Objectives (1997)	To provide retail funding for the government, consistent with the government's fiscal plan, and designed to balance cost, risk, and market considerations.	To maintain a reasonable and sustainable retail share of the total federal debt, therefore ensuring a broad investor base for the government debt.	To offer a family of attractive products, including new products in key market segments, thus benefiting all Canadians.
1995-1998 Business Plan	To run a cost effective retail debt program, including all costs for contracted services such as research and advertising, systems and commission paid on distribution. To perform within the approved budget. To be an innovative entrepreneurial performance organization.	To increase the federal debt held by retail to a maximum of 30% of total federal debt in the medium term. To reverse the decline in the share of the federal debt already held in the retail hands in the next two years. To provide high quality, user-friendly services.	To develop attractive new retail debt products and innovative new distribution approaches in partnership with the private sector starting in the first year and throughout the next ten years.
1997-2000 Business Plan		"Stop the declining trend" and retain the current CSB customer base by adding value to existing products, developing new products and revamping payroll.	To diversify the retail debt portfolio by developing new instruments in emerging and growing markets, therefore benefiting all Canadians.
1998-2001 Business Plan		In addition to more product options, a longer sales period and responsive pricing on the existing portfolio will also be key strategies for success in retaining and diversifying debt portfolio.	Increase diversification by growing the percentage of our bonds held in registered plans, such as RRSPs and RRIFs, and by introducing less-liquid alternatives, such as the Canada Premium and Stock-Performance Bonds.
1999-2002 Business Plan	Efficient Operations		Portfolio Retention Portfolio Diversification
2000-2003 Business Plan	Reduce costs through cost efficient systems and operations.	Maintain a diversified investor base. Maintain appropriate customer service levels. Market a strong Canadian brand.	Retain portfolio and diversify on a cost-effective basis.
2001-2004 Business Plan	Reduce overall costs and minimize unit costs over time in an environment of declining retail debt stock, while maintaining appropriate service levels Make our products and services available on-line by 2004	Maintain a diversified investor base that is inclusive and accessible to all demographic groups across all provinces and territories in both official languages Maintain and market a strong Canadian brand.	
2002-2005 Business Plan	Reduce the overall costs and minimize unit costs while balancing the need for investment in innovation	Maintain a diversified investor base. Maintain and market a strong Canadian brand. Establish and maintain appropriate service levels.	Maintain innovative products and services emphasizing all retail products and services online.
2003-2006 Business Plan	Reduce the overall costs and minimize unit costs in line with declining retail debt stock	Maintain a diversified investor base. Establish and maintain appropriate service levels. Maintain and market a strong Canadian brand.	Maintain innovative products and services emphasizing all retail products and services online.

Findings: Evolution from cost balance to cost effectiveness without any quantification, including conflicting objectives related to service, innovation and entrepreneurialism. Clear evolution to cost effectiveness in the context of declining stock

Findings: Transition from clear measurable market share and debt share objectives to more difficult to define objectives related to investor base, brand and appropriate service levels, in the context of managing the declining stock.

Findings: Shift from developing new products in partnership with private sector to diversifying for portfolio retention to cost effectiveness and finally to online channel emphasis. The evolution on this category, focusing on innovation, does not appear to be aligned with the cost effectiveness objectives that point to a declining stock.

Performance Measurements

Was the Program effective in measuring its performance and did the Program meet its performance targets?

We used a fact based approach to assess performance

- We gathered the Program's key performance measurements (KPMs) from 1997 to 2002 and calculated KPMs which had not been monitored during this period.
- We reviewed the evolution of the KPMs to assess their relevance and consistency with the documented objectives.
- We integrated insight from our internal stakeholder interviews and from our review of other programs.

We observed lack of rigour in the measurement process

- The KPMs are ineffective in evaluating the performance of the Program since they are too broad, do not isolate key business drivers and are not calculated or updated consistently.
- We found that the lack of quantifiable program objectives led to inconsistency in monitoring and measuring performance (e.g., pricing targets, share of debt, cost effectiveness)
- A number of factors make it difficult to assemble necessary financial information for compiling measurements and analyzing performance of the Program: lack of centralized of data, inconsistent account balances and breakdowns, lack of transparency in financial data in both Business Plans and Financial Statements, lack of articulated definitions for critical metrics.

The Program did not perform within a changing environment

- The non-marketable retail debt is consistently losing share within the overall federal debt portfolio (7% to 5%) and overall share of Canadian investable assets (2.5% to 1%).
- Expenditures in product development, marketing and infrastructure when compared to industry and other programs are high and not having a positive impact on sales or rate of redemptions.
- Canadian brand attitudes are not translating into sales, enrolment in payroll or higher retention rates.

The Program has not met important performance targets

- The stock and sales have decreased consistently over the period examined.
- The current cost structure of the Program is unsustainable given its lack of impact in attracting investors.
- Regardless of which strategic option the Program chooses, we recommend a more rigorous approach to establishing performance measures in line with revised Program objectives.

Value to Government

Does the Program provide value to the government?

We analyzed value to government using a rigorous evaluation approach

- Our ex-post cost analysis took a strict, private sector approach to each savings bond series in a sample that represented two thirds of outstanding bonds.
- Unlike other methodologies, we treated each 10-year series as an actual 10-year obligation in order to compare to wholesale debt costs the financial impact to government of each series' interest rate differential and refinancing of redemptions
- We encountered challenges in compiling and consolidating the necessary financial data from many sources, but are comfortable with the model's data, assumptions and analysis of conclusions.

The Program has lost importance as a source of funds

- Non-marketable retail debt represents a small and declining share of government debt, falling from 7% in 1996 to 5% in 2003.
- Changes in non-marketable retail debt outstanding demonstrate sensitivity to interest rate fluctuations similar to the wholesale debt portfolio. This sensitivity reduces the value of retail debt as a tool for diversifying based on debt holder behaviour.
- Recent balanced budgets have allowed the government to borrow in wholesale markets at more favourable rates; and recent '*retail*-ization' of marketable debt through money market and bond mutual funds has increased domestic ownership and also provided investor breadth.

The Program is an expensive source of funds

- Our analysis identifies that a substantial subsidy in recent pricing of CPBs coupled with high redemptions of CSBs – especially within the employer channel – have amplified the impact of declining stock of outstanding bonds at the expense of the Program.
- Our analysis of the sample calculates an option cost of approximately $150 million, comprising the net cost of both interest rate differential and refinancing, which when added to total operational costs of $895 million, brings the cost of the Program to more than $1 billion since 1997.

The Program provides little social value

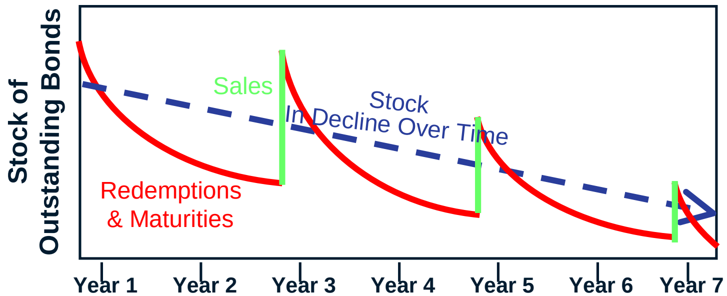
- Although the Program has a strong history of helping Canadians save conveniently, economic and social indicators suggest less savings behaviour now than seven years ago.
- Payroll program participation and sales have been flat with churn remaining high indicating it is being used more as a demand account to facilitate purchases than as a savings discipline.
- Investor education and messages about savings tactics are provided by many private and public sector organizations with greater direct access to Canadians.

Value to Government

We use these illustrations to help explain the financial drivers affecting value to government

Illustration:

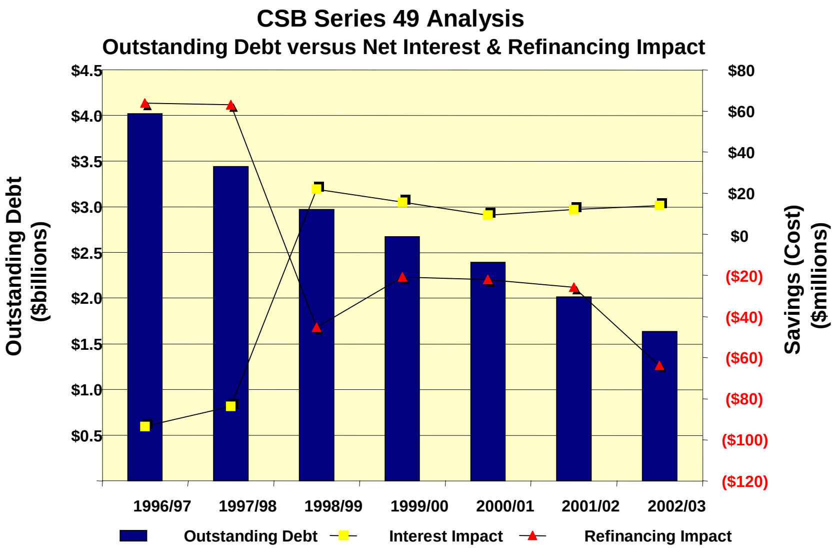
Sales not offsetting redemptions and maturities over time.



Vs.

Sales offsetting redemptions and maturities over time resulting in a balanced portfolio over time.

Actual Sample:



Financial Analysis:

- Non-marketable retail debt operating expenses increased from $110.8 million for the year ending March 31, 1997 to $141.3 million for 2000, and then declined to $118.8 million by 2003.
  - Total operating costs for 1997-2003 equal $895 million.
- The net impact of optionality – calculated by analyzing the financial impact of both interest differential and redemptions refinancing of a representative sample of 14 CSB and CPB series – amounts to an additional Program cost of $153 million.
  - Interest costs for the sample totalled $129 million
  - Refinancing of redemptions for the sample totalled $24 million
- When added to the total operating costs, the impact of optionality increases the overall Program cost for the last 7 years to more than $1 billion.

Value to Investors

Does the Program provide value to investors when compared to other savings and investment offerings?

We analyzed value to investors through the eyes of the customer

- We interviewed stakeholders and conducted research while drawing on our own insights into wealth management, retail banking and consumer behaviour.
- We analyzed the Program's product benefits and compared these to the range of other comparable products.

On the surface, the Program's features compared favourably

- CSBs and CPBs offer equivalent or higher rates than standard guaranteed investment certificates (GICs) offered by financial institutions and provide additional cashability and greater security for high balances that exceed CDIC limits.
- CSBs and CPBs have also outperformed non-GIC investments such as some equity and bond funds during the period 1998 to 2003. This supports our financial analysis suggesting rate subsidization during this period.

However, important trends make savings bonds less competitive

- The large banks who dominate both in market share and distribution have focused tremendous energy on deepening customer relationships by investing in technology, deploying sales skills and – most importantly – offering bonus interest rates that can range from 10 to 100 bps.
- Financial institutions can quickly adapt their pricing to interest rate volatility since they are not obligated to hold prices for an entire month; an especially important ability in this environment.

Only small segments continue to see value

- While accurate segmentation of bondholders is unavailable, surveys have identified that older, affluent Canadians purchase savings bonds through sales agents whereas younger less wealthy Canadians use the payroll program.
- We observe that the older segment is becoming more performance sensitive while the younger segment continues to use the savings bonds as a cash equivalent.

In the future, savings bonds will continue to be marginalized

- Future demographic and behavioural changes will lead to reduced relevancy of the products to those who have the largest share of investable assets.
- Assets in the hands of loyal bondholders will be inherited by a generation for whom savings bonds are not perceived as a competitive investment vehicle.
- Financial advisors will play an increasingly important role in guiding the investment decisions of affluent Canadians.

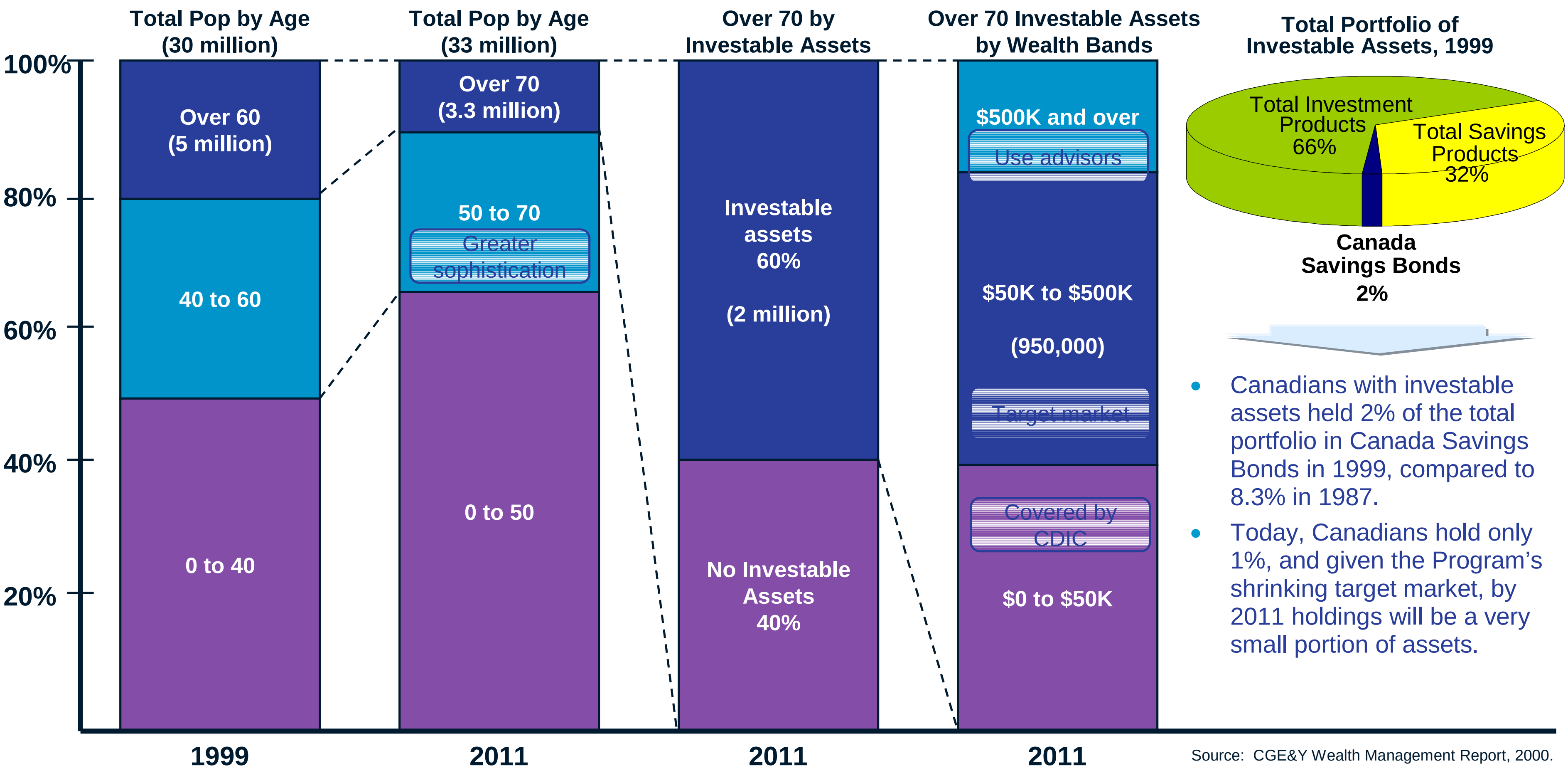
Department of Finance Canada Canada

Cap Gemini Ernst & Young

Value to Investors

We use this illustration to assess the future value to investors

- The investors who see the most value in the Program's offerings and who are the most loyal will shrink from approximately 1.4 million in 1999 to 950,000 by 2011. This is for two reasons:
  - By 2011, those Canadians who are over 60 today will be over 70 and represent a smaller segment of the overall population.
  - Canadians between the age of 40 and 60 today who will be 50 to 70 in 2011 will not exhibit loyalty to the Program's offerings and are predicted to be much more sophisticated in their approach to investment performance.



- Canadians with investable assets held 2% of the total portfolio in Canada Savings Bonds in 1999, compared to 8.3% in 1987.
- Today, Canadians hold only 1%, and given the Program's shrinking target market, by 2011 holdings will be a very small portion of assets.

Source: CGE&Y Wealth Management Report, 2000.

Environment

How has the market environment affected the Program's performance and what are the future prospects?

We assessed the environment using a number of sources

- We drew upon external research to build the analysis of the environment and combined it with CGE&Y's proprietary research into the Canadian wealth management industry.
- We also integrated the points of view from the various stakeholders that took part in focus interviews.

The financial services industry is extremely competitive

- The Canadian wealth management market is experiencing consolidation which is heightening competition and driving investments in product innovation, customer analytics and technology.
- The industry has also witnessed new entrants in the market place differentiating themselves through better products, access and returns.
- The financial sector is very sophisticated in its customer relationship practices in order to retain clients and grow the number of products and services per household.

Investors are demonstrating more sophistication in their behaviour

- The range of options available and access to information have increased the overall knowledge and sophistication of investors. Researching products and services is the third most frequent online activity among North American Internet users which is particularly striking since the average Canadian family with Internet access spends more than 32 hours a week online.
- Investors are exhibiting greater diversification in their investment portfolios, embracing alternative investments and taking advantage of access to global markets. They have a higher level of understanding of the benefits of asset allocation and financial planning due to greater interaction with professional investment advisors.

Future prospects for the Program are not favourable

- Canadians are predicted to be shifting toward post-materialist values placing greater emphasis on freedom, self-esteem and quality of life. In fact, healthcare tops the list of problems facing Canadians today according to a recent Environics poll.
- As such, they are starting to expect more fiscal responsibility from government at all levels and demanding that programs focus on those Canadians most in need.

Organization

Does the Program's organizational structure enable effective delivery of its offerings?

We used a fact based approach to assess the effectiveness of the organization

- CGE&Y reviewed and analyzed Program documentation from 1995 until 2003, including reports, memos and presentations from various stakeholders.
- We compiled the themes gathered through our internal and external interviews and compared organizational structures and performance to those of other retail debt programs.

The existing governance process does not create an environment of collaboration

- The reporting structure of the Program is unclear and different in practice than was defined in the Memorandum of Understanding leading to difficulty in decision-making.
- The governance model established for the Working Group, an advisory team to operations, and the Steering Committee, established to provide leadership and guidance, is not operating as effectively as it was intended (e.g., membership changes, missed meetings, difficulty gaining consensus).
- Each set of stakeholders has settled on their own valid objectives, making consensus difficult to achieve and challenging the planning, decision-making, and other operational processes.

The Program attempted to establish clear roles & responsibilities

- The Program struggled in establishing the roles and responsibilities of each stakeholder. A memorandum of understanding (MOU) was not finalized until 2000, 4 years after the inception of the Program.
- The Program continues to experience dysfunction within its management team – despite best efforts by individual team members – due to lack of clarity in overall accountabilities, roles and responsibilities.

The organizational structure does not enable effective delivery

- The current organization is not sustainable due to the high level of tension, difficulty in decision-making and frustration with planning and execution challenges.
- The Program should be run within one entity, with certain functions outsourced as appropriate, and roles and responsibility should be clearly defined and communicated.

Design

How viable is the Program's current design and how effective is product development, origination and servicing?

We analyzed Program design using a multifaceted approach

- We gathered, consolidated and analyzed channel and process data, and drew upon insights from stakeholder interviews and industry experience.
- We supplemented this analysis with secondary research to gain a current policy perspective.

Product Development has tried to keep pace

- The Program has introduced new products, like the CPB, to stem redemptions. However, the features are not sufficiently differentiated to secure a significant market share in the face of intense innovation and competition in the market.
- The product development process is hampered by an unclear mandate and conflicting objectives.
- Marketing efforts have differentiated the Program in the Canadian marketplace but have failed to reverse the erosion in market share.

Origination faces challenges difficult to overcome

- Payroll has been successful in maintaining its annual sales level at approximately $1 billion to $1.3 billion. However, the channel has not gained market share in the face of competing products and services, and increasing investor sophistication (i.e. high interest savings accounts, frequent purchase plans). Further, the payroll investors invest for short term needs, increasing the costs associated with this program through transactions and churn.
- The Sales Agent channel volume has been steadily decreasing because of poor relationships with FIs. This is due to lengthy sales periods, cumbersome processes, competing products and commissions and rates insufficient to motivate collaboration.

Servicing is meeting bondholder expectations, but at a cost

- A recent customer service survey indicates that the satisfaction levels are very high at over 90%. This service level, compared to our FI and service benchmarks, points to a case of "over delivery".
- Stakeholders who were interviewed identified many cost drivers in the service functions.
- These cost drivers include a proliferation of channel volume despite migration efforts, an increasing number of processing exceptions and frequent bondholder demands, especially among payroll program enrolees.

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Our findings indicate that Rundown is the most relevant option

Franchise Value

	Question	Findings	Basics	Rundown
Objectives	Was the Program effective in setting objectives and did it meet its objectives?	• The Program was not effective in consistently meeting objectives. A more rigorous approach to objectives setting and a revision of business goals aligned with the overall government debt strategy must be implemented.	☑	☑
Value to Government	Does the Program provide value to the government?	• The Program has lost importance as a source of funds to government which has seen non-marketable retail debt decline as a share of overall debt. The Program is also an expensive source of funds, providing little perceived social value.	☑	☑
Value to Investors	Does the Program provide value to investors when compared to other savings and investment offerings?	• A small and shrinking segment of the investors see value. It is expected that savings bonds will continue to be marginalized in the future as investors gain more sophistication through availability of information and advisory services.		☑
Environment	How has the market environment affected the Program's performance and what are the future prospects?	• The market has significantly impacted the Program and is expected to continue to put pressure on rates, innovation and responsiveness. Canadians are expecting more fiscal responsibility, demanding more focus and value from government.		☑
Organization	How does the Program's organizational structure enable effective delivery of its offerings?	• The organizational structure does not enable effective delivery of the offerings and should be run within one entity, with clear roles and responsibility.	☑	☑
Design	How viable is the Program's current design and how effective is product development, origination and servicing?	• The Program Design is unsustainable and it is expected that even with a modified design, it will continue to exhibit difficulty in the face of intense market competition.		☑

Conclusion

The Basics option remains more costly than the Rundown option, including the cost of restarting the Program as a necessary source of future funds

Continuing the Program under the Basics Option	← VS. →	Discontinuing the Program under the Rundown option

Considerations:

- Restructuring costs have not been included.
- Taxpayers may not react positively to subsidizing this Program within the current environment of fiscal prudence and a focus on healthcare.
- Maintains only a minimal franchise, which, in the case of a need for a significant source of funds, the government would need to follow a similar scenario as the one depicted on the following page.
- Basics option is estimated at $55M per year with an estimated life of *15-20 years* before the Program is discontinued due to insufficient stock to warrant infrastructure→**$825M to $1.1B** A

Considerations:

- Restructuring costs have not been included.
- Possibility of communicating this discontinuance as a wider effort to cut costs of government, to be more fiscally responsible and to focus on the priorities of Canadians.
- Backlash from certain segments of Canadians regarding the rundown or close of the Program.
- Rundown option is estimated at $40M per year with an estimated life of *10 years* → **$400M** B
- We define a restart of the Program based on a scenario where the dealer network would be leveraged. See following page for potential scenario. The incremental start-up cost is at estimated approximately → **$1M** C

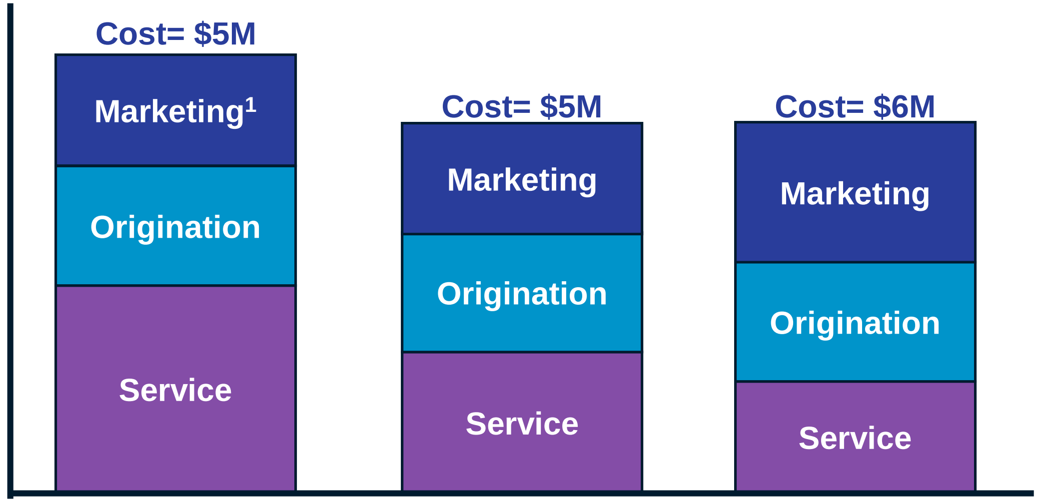
<u>Conclusion</u>: A > (B + C)

The Basics option exceeds the cost of the Rundown option. The incremental cost is estimated to be in the range of $420M - $695M.

Conclusion

Illustration of a potential restart of the Program

Scenario 1 | ***Scenario 2*** | ***Scenario 3***



Basics

- Servicing with existing and rationalized infrastructure
- Competitive rate and commissions
- Marketing campaign – generate large volume outsourced to external party

Rundown

- Servicing costs reduced – using minimal infrastructure in place
- Competitive rate and commissions
- Marketing campaign to generate large volume, outsourced to external party

Closed

- Outsource servicing at market rate[2]
- Competitive rate and commissions
- Marketing campaign to generate large volume, outsourced to external party – expected to be more costly to refresh the investor and dealer enthusiasm

Premise: The government needs to raise a substantial amount of non-marketable debt.

Illustrative Scenario:

- Leverage the dealer channel with a revamped product:
  - pay (e.g.) 75 - 50 bps of commissions up front,
  - set a rate that will attract investors and advisors (e.g. 25 - 50 bps below bank rate) implying segmentation vs. universality,
  - issue non-certificated bonds with $5,000 minimum purchase amount.

Rationale: The bulk of the investment must be made in the origination (rates, commissions) and dealer relationships/marketing.

The servicing and the marketing should be outsourced to keep the Program flexible to meet government requirements while maintaining the fixed costs low.

Conclusion: The total cost of restarting the Program once it is completely closed is $6M and is $5M under either of a Basics or Rundown business model.

Since origination and servicing are operating expenses and would be necessary under any scenario, the only incremental cost of “restarting” this Program once it is closed is $6M less $5M or ***$1M***.

Note 1: The UK's National Savings & Investments engaged in a re-branding campaign which heightened public awareness of an existing retail debt program at a cost of £2 million ($5M) per the program's CEO . [Information withheld]

Note 2: Based on our most recent market rate research of third party service providers an estimate of the cost of administration would be $0.50 per bond per month.

Conclusions

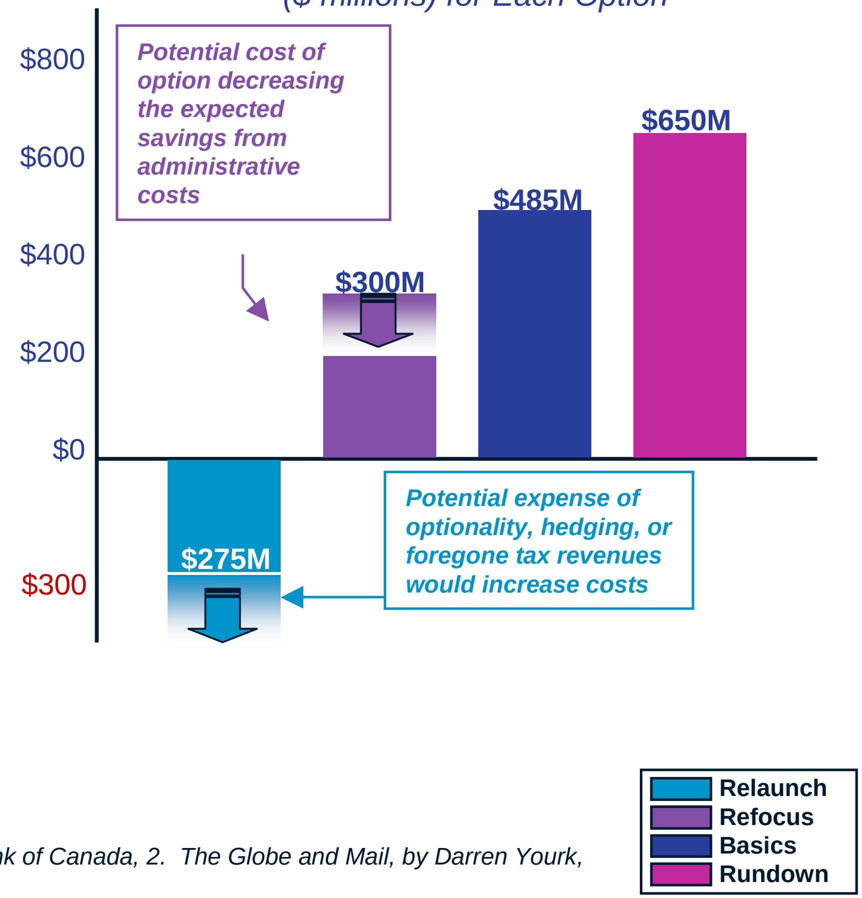
The Rundown option is our suggested course of action

- The Basics option presents government with the most cost effective option to maintain the Program, providing Canadians the opportunity to invest in government non-marketable debt – a minimal franchise.
- Based on our integrated analysis of Program objectives, value to government, value to investors, current and future environment, organization structure and program design we conclude that Rundown is the suggested course of action.
- We feel the Rundown Option is aligned to the current priorities of government, as articulated by Minister Goodale in a recent news release:

  "The government's main priorities include finding permanent savings of $1 billion per year from existing federal program expenditures and developing a new culture of good governance and responsible government spending."[2]

- We recommend Rundown as the option that delivers the appropriate solution in today's environment and the maximum amount of savings relative to current cost projections.

Estimated Savings compared to the current Program ($ millions) for Each Option[1]



Sources: *1. CGE&Y financial models created with data provided by CI&S and the Bank of Canada, 2. The Globe and Mail, by Darren Yourk, Article: Goodale kicks off pre-budget tour.*