Canaccede Financial Group

Presents

The Future of Insolvency Account Management in Canada

Dealing with the shift while reducing expenses and increasing returns

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1. Executive Summary

The last 10 years has seen a protracted period of wealth creation driven by home equity appreciation, low interest rates and strong economic growth. As these conditions begin to reverse, consumers will experience significant decreases in home equity, increases in their debt servicing costs, and stagnant income from higher unemployment due to macroeconomic and political headwinds expected in the coming years and is forecasted to drive an increased number of consumers towards insolvency filing to manage mounting debt payments and reset their personal balance sheets.

For an average Canadian bank, Consumer Proposal ("CP") and Bankruptcy ("BK") filings already represent a material portion of their credit losses – between 30-50% of overall default rates annually. Depending on loan book size and composition, this means anywhere from $300-$400 million of assets annually are subject to insolvencies, with these figures forecasted to rise going forward.[1]

Going forward, lenders should therefore expect an increase in filings and a decrease in the recoverability of estates. This will put pressure on internal insolvency teams and corporate balance sheets. To prepare for these new and more demanding conditions lenders should consider turning to specialized filing and recovery services that are better equipped to manage and optimize insolvency filings.

More recently, there has been a shift in the insolvency market with the introduction of a "fully wrapped" service and sale offering which provides the following benefits for creditors:

- Elimination of operating expenses associated with account management
- Ensures the provider is fully incentivized to invest in the platform and optimize recoveries
- Allows for the obtainment of a higher NPV than the creditor can achieve independently, given the required equity return discount rate
- Provides credit loss predictability and stability during periods of increased insolvencies or economic pressure
- Applies a sophisticated and advanced privacy and security protocols against all integration points

Taken together, we expect these factors to cause a near term material shift in the filings, servicing, and purchase markets for insolvent accounts. Economies of scale, realization expertise, recovery transparency, data analytics, and machine learning are expected to drive this market towards a small number of aggregators who will be able to deliver tangible benefits for the operations, risk management, finance and technology groups of lenders. Lenders who engage quickly will earn a significant early adopter advantage that will allow them to define the market dynamics and to benefit from increased pricing power. Late adopters will miss this opportunity and will be subjected to higher losses and less market control while they attempt to catch up.

InsolvencyStream™ by Canaccede is a fully customizable, scalable, and modern insolvency receivables administration tool that allows financial institutions to gain more from their insolvent accounts during a dynamic and challenging time in the market. Partnering with Canaccede offers the peace of mind of working with the largest and most experienced receivables buyer in Canada.

InsolvencyStream™ gives creditors the flexibility to pick the solution that matters most to them. Whether it is account management and servicing or having Canaccede purchase and process the insolvency, there is a tailored solution for any need. This flexibility and scale allows lenders to choose how they want to reduce costs, maximize recoveries and minimize risk.

Canaccede has the expertise to integrate seamlessly with our partners' operations to provide the value-added services that they need. InsolvencyStream™ is the proven one-stop solution for Canadian lenders who are committed to advancing the sophistication of the administration of their insolvent accounts.

[1] Estimated based on financial reporting of the Big-5 Canadian banks

2. Canadian Insolvency Market Overview

Macroeconomic factors and insolvency trends suggest an increasing incidence of insolvency, as consumers struggle to manage debt payments and protect their home equity.

2.1. Macroeconomic Factors

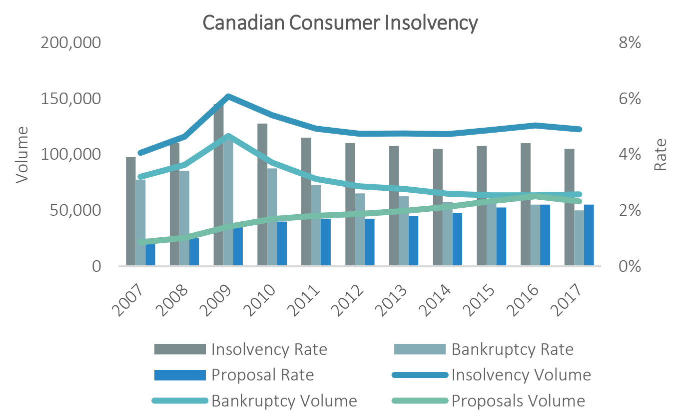
After instituting 10 years of low interest rates, the Bank of Canada raised its key rate twice in the back half of 2017. More Canadians are already feeling the squeeze, and there is rising pressure for further rate hikes going forward. According to the latest poll conducted by market research firm Ipsos, nearly half of Canadians are now within $200 of being unable to pay their bills and meet their debt obligations, including one in three who say they have no money left at the end of the month and cannot cover their payments.[2]

The driving force behind the squeeze on consumer finances is the carrying of massive debts by Canadians from a long period of abnormally low interest rates. During the period of 2013 to 2017, household debt as a proportion of disposable income has risen from 147% to 168%.[3]

In addition, rising home values have allowed owners to use home equity lines of credit ("HELOCs") to pay other debts or simply fund their lifestyles. According to the Financial Consumer Agency of Canada, outstanding HELOC balances totaled $211 billion in 2016, having soared from $186 billion in 2010.[4] As the pace of home price appreciation slows down and the prospect of a real estate market correction increases, over-indebted households will face debt servicing shortfalls without the safety net of home equity refinancing. This will force more households into insolvency filings to restructure their obligations and meet their financial commitments.

2.2. Insolvency Trends

Insolvency trends in Canada have already begun rising, with overall rates consistently above their pre-recessionary levels in recent years. Consumer Proposals have been increasingly used to address financial strain, which has been partly offset by a decrease in bankruptcy rates. This shift in proportion is due to a combination of factors: a change in bankruptcy legislation, enhanced margins for trustees in these arrangements, and consumers' desires to protect their home equity.



Source: "Annual Consumer Insolvency Rates by Province and Economic Region", *Office of the Superintendent of Bankruptcy Canada Statics and Research*. https://www.ic.gc.ca/eic/site/bsf-osb.nsf/eng/br01820.html.

The rising number of proposals represents increased requirements for creditors to review submissions, vote on their acceptability, and to monitor adherence to plan. Given that such requirements are resource-intensive but generate low returns, many creditors have opted to outsource servicing to third parties rather than dilute profitability ratios by building such capabilities in-house.

[2] "Personal Finances Getting Worse: Nearly Half of Canadians (48%) Within $200 of Insolvency Every Month (+6 pts)", *Ipsos News & Polls*. January 15, 2018, https://www.ipsos.com/en-ca/news-polls/MNP-Debt-Index-W3-2018.
[3] "Distribution of household economic accounts, wealth indicators, Canada, regions and provinces", *Statics Canada CANSIM Table 378-0155*. March 22, 2018, http://www5.statcan.gc.ca/cansim/a26?lang=eng&retrLang=eng&id=3780155&tabMode=dataTable&p1=1&p2=-1&srchLan=-1&pattern=household+debt+income.
[4] Joe Castaldo, Maclean's, "How Canadian homes become debt traps", *Money Sense Real Estate*. November 13, 2017, http://www.moneysense.ca/save/debt/how-canadian-homes-became-debt-traps/

3. Bank Impact Assessment

3.1. Financial Exposure

Insolvencies constitute 30-50% of a prime lender's retail credit losses, which are increasingly subject to lower recoveries due to unfavourable market dynamics.

Based on statistics from the Office of the Superintendent of Bankruptcy, there are approximately $2-3 billion of total consumer insolvency receivables currently outstanding in Canada, with $1-1.5 billion of new insolvencies every year.[5]

- For an 'average' Big-5 bank, this equates to approximately $325-$425 million in annual retail losses attributed solely to insolvency filings, making up between 30-50% of a bank's total credit retail loses.[6]
- This generates $30-$40 million of insolvency recoveries annually,[7] which are placed at risk by inefficient trustee follow-up processes, with improperly managed accounts generating no recoveries pre-termination.
- Insolvency rates are impacted by excess income, employment, housing equity levels, and trustee market competitiveness, all of which can be adversely affected by economic stagnation, leading to lower recoveries.
- By delaying receipt filings until trustees and regulatory fees are paid, recoveries from current period filings are deferred significantly – sometimes for up to 3-5 years after the insolvency event.
- As a result, during periods of rising insolvency, recoveries from previous periods are insufficient to proportionally offset current losses. The net impact is an increase in net credit losses above normal levels, and a necessity to increase credit loss provisions to accommodate.

3.2. Operating Expense Estimates

The fully accrued operating costs associated with managing insolvent accounts can be minimized or eliminated through an outsourcing or an outsourcing and sale solution model.

The operating costs associated with managing insolvent accounts vary significantly. Some filings are relatively standard, whereas others could require extensive involvement and custodial services of the estate.

- On average, a Canadian Bank spends $100-$150K/month on insolvency processing when factoring in both direct and indirect overhead. With the additional cost of monitoring and managing receipts, this expense increases to $2-$3 million per year.[7]
- The outsourcing of these activities allows lenders to capture economies of scale and be charged only the marginal cost, as opposed to the average cost. This brings down service expenses by ~25%.[7] If these assets are part of a service-and-sale strategy, operating cost is eliminated entirely.

3.3. Impact on Equity Return Rates

As IFRS and Basel rules require insolvent accounts to receive full equity allocation on a Bank's financial statements, recoveries need to be discounted at the Bank's return on equity levels for current valuation.

When evaluating strategies for insolvent accounts, the discount factor applied against free cashflow is the Bank's equity return. As a result, recoveries associated with insolvent receivables are net dilutive to financial results, making it advantageous to capitalize on discount rate arbitrage and divest in the accounts rather than realize on them.

[5] "Statistics and Research", *Office of the Superintendent of Bankruptcy Canada*. https://www.ic.gc.ca/eic/site/bsf-osb.nsf/eng/h_br01011.html
[6] Estimated based on financial reporting of the Big-5 Canadian banks
[7] Estimated based on Canaccede's historical experience on insolvency recovery and servicing cost, as well as industry pricing intelligence.

4. Insolvency Servicing Landscape

Legacy insolvency servicing solutions will struggle to meet rising volumes at the expense of creditors, who will be forced to accept significantly lower recoveries.

The Canadian insolvency industry is very fragmented with many trustees and creditors. Even though the top 4 trustee firms constitute around 30% of the market share, the top 20 firms have less than 70%.[8] Moreover, larger trustee firms are often composed of multiple offices in different locations, each with independent contact points.

On the other hand, the technology and processes underlying insolvency servicing platforms for creditors have remained relatively unchanged over the last decade. Whereas financial technologies in payments, lending, and customer service have benefited greatly from investments in their platforms, the defaulted and insolvent consumer management space has remained relatively stagnant. This is partly due to the disincentive that a contingency-based, low-margin servicing arrangement has on the investment return for platform development costs.

4.1. Common Problems

Given this market fragmentation, trustee interaction becomes a resource-intensive process with these issues:

- Identifying the right trustee office with widespread decentralization among larger trustees.
- Monitoring and compliance with a dynamic regulatory framework outlined by the OSB.
- Executing quick turnaround of documents exchange with trustees, and tracking account status through its lifecycle, from proof of claim filing and voting at the beginning to completion or annulment at the end.
- Managing the frequency of payments and following-up on outstanding items, as trustees remit payments to creditors at different intervals – monthly, quarterly or even annually.

These administrative requirements become operationally burdensome for creditors, rendering insolvency management a high-touch/low-return activity. More importantly, inefficient insolvency management in the face of rising volumes results in lower recoveries for creditors as it is difficult to scale up review and approval requirements, which leaves significant unrealized value in submitted proposals.

4.2. Insolvency Service Outsourcing

In response to these operational and compliance risks, financial institutions are better suited to outsource these processes to qualified third parties. By externalizing delivery, the financial institution can capture the economies of scale that come from centralization but avoid the risk of volume fluctuations. They are then able to transfer this execution risk to a specialized corporate vendor who establishes service level terms under contract, which can be easily monitored with appropriate avenues for recourse.

4.3. Market Disruption

In 2018, there is significant disruption in the Canadian insolvency servicing market driven by the consolidation of incumbent providers into larger entities. Low margin divisions are increasing being deemed non-strategic and non-growth areas, which is driving parent companies to under-invest in the platforms or divest completely. As a result, there is a diminishing number of capable service providers in the space able to deliver the service-level-commitments needed for this specialized function. Concurrently, expanded accessibility of cloud-based software as a service (SaaS) solutions via fintech businesses is introducing new solutions that are more flexible, extensible, and inexpensive than those of the legacy incumbents.

[8] Estimated based on Canaccede's historical observation of insolvency volumes by trustee

5. Solution Benefits

5.1. Sale and Service Solution Model

Concurrent to outsourcing servicing, selling insolvencies further optimizes economics for the Bank, decreasing operating costs and increasing equity return.

The integration of an insolvency solution from a service only to a service-and-sale model provides the most comprehensive proposition for capturing value for both the buyer and the seller.

- A fully wrapped solution blends the economics of disparate functions, thereby optimizing value to creditors.
- By blending the economics of multiple solutions, servicing and investment activities do not each need to attract a margin, thereby allowing for higher asset values.
- Front end management allows for greater transparency into underlying proposals, enabling a lower required risk premium and therefore higher pricing.
- Elimination of the "Notice of Assignment" activity reduces servicing cost and promotes the efficiency and reliability of trustee relationships.

Once established, there are distinct benefits to various functions within the Bank:

Operations & Collections

- Decreases/eliminates operating expenses associated with insolvency recovery.
- Achieves a superior NPV than retaining ownership via discount rate arbitrage.
- Provides a more efficient platform for management and reporting than alternatives.
- Reduced compliance requirements and the associated cost.

Finance & Treasury

- Achieves a higher ROE than asset retention due to capital allocation requirements.
- Allows for more explicit valuation of assets on the balance sheet given pricing in place.
- Generates a stable and lower net credit loss rate against the corporate income statement.
- Reduced operational risk flows through to lower capital requirements.

Risk Management

- Allows for smoothing of PCL rates during periods of economic downturn.
- Eliminates operational risk associated with filing and realizing on filings.
- Ensures optimal, predictable and matched realization of assets against their default values.

Technology

- Ensures all security, privacy and data integrity standards are properly prioritized.
- Utilizes current and sophisticated integration points for more efficient data transfer.
- Provides virtually unlimited flexibility and extensibility to meet volume fluctuations.

Banks that pursue this option end up, on average, seeing a 25-35% increase in the present value of their insolvency assets, and a decrease in the operating costs of 80-90% associated with the recoveries.[9]

When a fully wrapped solution is combined with sale of existing insolvency receivables, the bank generates a one-time benefit from initiative on the warehouse sale, an instant benefit from the establishment of a forward flow arrangement, and a sustained and consistent over-performance in insolvency realization on a go-forward basis.

[9] Estimated based on Canaccede's historical experience on insolvency recovery and servicing cost, as well as industry pricing intelligence.

6. Why InsolvencyStream™?

InsolvencyStream™ is a fully extensible and customizable platform that allows the bank to have a dependable solution for either or both servicing and/or selling insolvency accounts, eliminating any costs or risk associated with greenfield development.

- A full solution from a leader in the field
- A servicing platform that reduces cost, enhances compliance and reduces operational risk
- A purchase solution that eliminates costs, risk and adds value
- A fully wrapped, future proof solution that generates synergistic benefits for you

Enhanced Solution: Canaccede has extensive experience in the insolvency industry, with expertise in account management pre-filing and in the administration of large portfolios of insolvent receivables. Canaccede holds the following market positions:

- The largest and most experienced acquirer and servicer of insolvency receivables in Canada.
- The only purchaser of insolvency receivables with experience in forward flow arrangements. No other active buyer, domestic or foreign, has experience acquiring insolvencies via forward flows in Canada.
- The only fully integrated service and purchasing provider in the Canadian market. By running an internal servicing structure, Canaccede can arrange both servicing and purchasing agreements collectively. Execution risk for the Bank is materially lower than establishing a new buyer on forward flows and negotiating a servicing agreement with a third party.

Eliminates Credit Risk: Under a sole servicing arrangement, the credit risk associated with account liquidation remains with the creditor. If economic conditions worsen and liquidation rates decrease, or annulment rates increase, that cost is borne fully. Under a sale solution, the creditor would fix their salvage value on insolvent accounts and eliminate the risks.

- Canaccede is an active manager of its accounts, not simply an investor. This means we have a vested interest in optimizing the value from accounts and maintaining a positive market reputation with the insolvency community. Canaccede can blend the returns from servicing and purchasing, limit unnecessary operational burdens, and optimize the servicing accounts for enterprise level benefit without the constraint of marginal servicing fee return.

For more information on the platform, please contact any of the following people:

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