Canada Deposit Insurance Corporation

Société d'assurance-dépôts du Canada

Compensation Backgrounder

Canada

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Overview[1]

Where CDIC uses one of its resolution tools to resolve a failing financial institution, it is expected that the creditors and shareholders of the financial institution will be in a better financial position than if the institution had simply been liquidated (or wound up)[2]. This is because the losses incurred in liquidation through the closure of the financial institution would generally far outweigh the losses that would be incurred through the use of one of CDIC's resolution tools.

However, if that were not the case, the *CDIC Act* provides an important safeguard to ensure that creditors and shareholders of the financial institution are compensated when CIDC's actions mean they are worse off than they would have been in a liquidation.

This protection is consistent with international standards and best practices.

International context

Canada has been an active participant in the G20 financial sector reform agenda aimed at addressing the contributing factors to the global financial crisis that began in 2008. This includes international efforts to address the potential risks to the financial system and to the broader economy posed by systemically important financial institutions perceived as "too big to fail."

Following the financial crisis, the Financial Stability Board (FSB) set out the responsibilities and powers that authorities should have in place to resolve large complex financial institutions. These international standards are known as the *Key Attributes of Effective Resolution Regimes for Financial Institutions* (the "Key Attributes"). The objective of the Key Attributes is to make it possible for authorities to resolve a large, complex financial institution in a manner that protects eligible deposits, maintains the flow of critical financial services, protects the economy, and minimizes risk to taxpayers.

The Key Attributes set out essential features that should be part of the resolution regimes for financial institutions in all jurisdictions. One of these features relates to the safeguards that resolution regimes should contain to protect affected creditors of the failed institution. These safeguards ensure that creditors are not made worse off in resolution than they would have been in liquidation.

[1] Nothing in this section prevents CDIC as resolution authority from fully exercising its powers in accordance with its objects under the *CDIC Act*.
[2] The liquidation would occur under the *Winding-Up and Restructuring Act*.

Specifically, Key Attribute 5.2 states:

Creditors should have a right to compensation where they do not receive at a minimum what they would have received in a liquidation of the firm under the applicable insolvency regime ("no creditor worse off than in liquidation" safeguard).

Compensation regime

The legislative framework for CDIC's compensation regime is set out in the *CDIC Act*. It includes a test for compensation, which entitles creditors and shareholders of the financial institution to compensation if CDIC's actions to resolve a failed institution leave them worse off than they would have been if the institution had been liquidated (the No Creditor Worse Off or NCWO test).

Under the statutory authority of the *CDIC Act*, the *Compensation Regulations* set out who might be entitled to compensation, provide further details on the test for determining a creditor's or shareholder's eligibility for compensation, and outline procedural requirements.

Who might be entitled to compensation?

A creditor or shareholder may be entitled to compensation if they held shares or certain liabilities of the failed financial institution at the time the institution entered into resolution (which is the date the Governor-in-Council [GIC] order was issued).

Under the *Compensation Regulations*, the following may be entitled to compensation:

- Holders of bail-in debt that has been converted into common shares pursuant to the bail-in power
- Holders of non-viability contingent capital (NVCC) instruments[3] that have been converted into common shares pursuant to their contractual terms
- Debtholders whose subordinated debt has been transferred to CDIC (see FIRP)
- Shareholders of the financial institution
- Holders of any liability of the financial institution, if the institution was liquidated (or wound up) at the end of the resolution process

[3] NVCC includes preferred shares and subordinated debt that, according to the terms of their contracts, convert into common shares if the financial institution becomes non-viable.

- Holders of any liability of the financial institution that was assumed by either a CDIC-owned workout company[4] or a bridge institution, which was subsequently liquidated or wound up

Who is not entitled to compensation?

The compensation regime is designed to protect those affected by CDIC's actions. Anyone not affected by the resolution will not be entitled to any compensation. For example, people whose liabilities have been assigned to a third party (such as a bridge institution) or people whose claims had been paid in full (i.e., were "made whole") during the resolution will not be entitled to compensation.

For the purposes of the compensation process, someone who may be entitled to compensation cannot transfer that right to someone else.

How will compensation be calculated?

"No Creditor Worse Off" test

The test for determining whether a person is entitled to compensation is:

Compensation = Liquidation Value – Resolution Value[5], where

- **Liquidation Value** = an estimate of what the person would have received if the entire financial institution had been liquidated. Liquidation Value will be estimated as of the date the financial institution entered resolution (i.e., the date of the GIC order).
- **Resolution Value** = an estimate of the aggregate value that the person retained or received (or will receive) through the resolution process. For example, in a bail-in scenario this would include both:
    - the value that the person **retained** through the resolution (for example, any common shares that are not transferred to CDIC and are retained by pre-existing shareholders), and
    - the value that the person **received** during the resolution process, from CDIC, the financial institution, or a liquidator (for example, common shares that bail-

[4] Workout companies are companies charged with managing or disposing of troubled assets in an orderly manner.
[5] The test for holders of NVCC instruments is different than for other people who may be entitled to compensation. It is as follows: compensation = liquidation value – resolution value – an amount equal to an estimate of losses attributable to contractual conversion. This is to ensure that those people are compensated only for actions taken by CDIC during the resolution and not for the conversion of their instruments into shares, given that they agreed to the conversion risk when purchasing these instruments.

in debtholders received as a result of the bail-in conversion or any other cash or securities received in the resolution process). Resolution Value will be estimated as of the date that CDIC no longer has control or ownership of the failed financial institution (for example, when the financial institution is returned to private sector control or is liquidated). If someone who is entitled to compensation sells their share or liability before that date, CDIC will estimate the Resolution Value as if the sale had not taken place.

The test will be calculated for each class of shares or liabilities that a creditor or shareholder held at the time the financial institution entered into resolution (i.e., the date of the GIC order).

In determining the amount of compensation a creditor or shareholder is entitled to, CDIC cannot compare their situation to how other creditors or shareholders fared in resolution (for example, a creditor will not be owed compensation solely because lower ranking shareholders or creditors retained or received shares or liabilities with some value in resolution).

Compensation will only be payable by CDIC where the Liquidation Value is greater than the Resolution Value. No compensation is payable when a person's Resolution Value is greater than (or equal to) their Liquidation Value.

Assumptions

CDIC is required to make certain assumptions when determining the offer of compensation. For example, in estimating the Liquidation Value, CDIC must assume that the financial institution would not have received any financial assistance or support from CDIC, the Bank of Canada, the Government of Canada, or a provincial government as part of the liquidation.

How will the compensation process work?

The compensation process begins when CDIC no longer has control or ownership of the failed financial institution (for example, when the financial institution is returned to private sector control or is liquidated).

To implement the compensation process, CDIC will:

- **Identify the people** who might be entitled to compensation (Identified Persons).
- **Determine the value of** each person's share or liability at the time the financial institution entered into resolution.

- **Determine whether any compensation is owed** by calculating Liquidation Value and Resolution Value. CDIC (or a valuator engaged by CDIC) will have a reasonable amount of time to conduct the necessary valuations.
- **Provide notices.** CDIC must provide each person with an offer of compensation or notify them that no offer of compensation is being made. CDIC must make the same offer to people who held shares or liabilities of the same class in proportion to the value of their claim. Shares or liabilities will be considered to be in the same class if they would rank equally in the event of a liquidation of the financial institution and received equivalent treatment in the resolution.
- **Publish a summary** of the offer of compensation (for each class) in the *Canada Gazette* and on the financial institution's website.
- **Collect any objections** to CDIC's offer of compensation (or lack thereof), for the purposes of appointing an assessor. People will have 45 days from the date of publication in the *Canada Gazette* to notify CDIC whether they accept or reject CDIC's offer. If they do not notify CDIC within the 45 days, they are deemed to have accepted the offer. Once a person accepts CDIC's offer or fails to respond, they will no longer have any claim against CDIC or the financial institution.
- **Distribute any compensation.**

CDIC may retain professionals (i.e., qualified persons or firms that have experience administering claims processes, such as licensed insolvency trustees) to help it administer the compensation regime and complete the steps above.

What if someone disagrees with the Notice of Compensation?

Within 45 days of the date of publication in the *Canada Gazette,* anyone who disagrees with CDIC's offer of compensation must notify CDIC that they reject the offer.

If someone who held 10% of the value of the debt of a given class, or 10% of the shares of a given class[6], object to CDIC's offer, the GIC is required to appoint a judge (an "assessor") to review CDIC's determination of compensation.

Only the people who object to CDIC's offer *and* are part of a class that meets the 10% threshold will have their compensation determined by the assessor. Those who accept CDIC's

[6] The test for common shares is 10% of the number of common shares, and the test for preferred shares is 10% of the liquidation entitlement (amount the holder is entitled to in liquidation with priority over lower-ranking shares) of the shares of a given class.

offer or fail to respond or who rejected CDIC's offer but the 10% threshold was not reached, will receive the amount set out in the offer.

In reviewing CDIC's offer and determining the amount of compensation owed, the assessor is required to consider whether the offer was reasonable and consider the same factors that CDIC was required to apply when making its initial determination of compensation. The assessor might determine that a different amount is payable, which could be either higher or lower than CDIC's offer.

The assessor's determination of compensation owed is final, and there are no further opportunities for review or appeal in any court or tribunal.

When will compensation be paid?

- People who accepted CDIC's offer of compensation, failed to respond to the offer, or rejected CDIC's offer but the 10% threshold was not reached, will be paid within 90 days of the expiry of CDIC's offer of compensation.
- In situations where an assessor was appointed as the 10% threshold was reached, payment will be made within 90 days of the assessor's final determination.

Compensation will be paid from CDIC's funds. CDIC is funded through deposit insurance premiums assessed against its member institutions.

Stylized example – Compensation (Bail-in debtholder)

The following is a simplified example to illustrate how compensation entitlements might be determined. It is based on a hypothetical financial institution, ABC Bank, that is resolved by CDIC through a bail-in resolution. This example calculates the compensation for a bail-in debtholder only. Other people affected by the resolution could have different entitlements to compensation. The situation would be more complex in practice.

Assumptions

- Following an OFSI non-viability report on ABC Bank, CDIC recommended to the Minister one of its resolution tools, namely that ABC Bank's shares be vested in CDIC. Subsequently, CDIC took control of ABC Bank in accordance with a GIC order (see EFIRP).

- XYZ Fund, a hypothetical investment fund, held bail-in debt (senior debt) issued by ABC Bank with a principal amount of $1,000 when the bank entered into resolution.
- During resolution, CDIC converted XYZ Fund's debt into common shares.
- XYZ Fund received 220 common shares.

Test for determining compensation

Compensation = Liquidation Value – Resolution Value

Estimation of Liquidation Value

Liquidation Value is an estimate of what a person would have received if the entire financial institution had been liquidated.

After completing a detailed valuation, CDIC estimates that, in a hypothetical liquidation of ABC Bank, holders of senior debt would have received 70 cents for each dollar of senior debt held.

The Liquidation Value of XYZ Fund's bail-in debt would therefore be:

$1,000 x $0.70 = **$700**.

Estimation of Resolution Value

Resolution Value is an estimate of the aggregate value that a person retained or received through the resolution process as of the date that CDIC no longer has control or ownership of the financial institution.

After conducting a detailed valuation, CDIC estimates that the value of each share provided in exchange for the converted debt, determined at the time when CDIC no longer has control or ownership of ABC Bank, is $5.

The Resolution Value of XYZ Fund's common shares (received through the resolution process) would therefore be: 220 shares x $5 = **$1,100**.

Offer of compensation

Compensation is calculated using the following formula:

Compensation = Liquidation Value – Resolution Value

In the case of XYZ Fund, the amount of compensation in respect of its bail-in debt would be zero because the Liquidation Value is less than the Resolution Value:

Compensation = $700 – $1,100 = –$400.

As a result, CDIC would make an offer of compensation of **$0** to XYZ Fund in respect of its bail-in debt.