

# Guidance on the Exercise of Eligible Financial Contracts Close-out Rights in a Resolution Scenario

March 1, 2018



This guidance note<sup>1</sup> provides an overview of the framework for the treatment of eligible financial contracts (“EFCs”)<sup>2</sup> between CDIC federal member institutions (“FIs”) and their contractual counterparties in the context of the resolution of a FI under the *Canada Deposit Insurance Corporation Act* (the “CDIC Act”).

Where a non-viable FI enters resolution, certain rights of EFC counterparties to terminate or accelerate obligations and to deal with financial collateral (collectively, “Close-Out Rights”) are stayed under the CDIC Act.<sup>3</sup>

In keeping with the Financial Stability Board’s *Key Attributes of Resolution Regimes for Financial Institutions* (the “FSB Key Attributes”), the stays on Close-Out Rights are limited. The framework is designed to strike a balance between a robust resolution toolkit that prevents mass termination of EFCs in the resolution of a FI and adequate safeguards for the rights of EFC counterparties to manage their risk.

## CDIC and Resolution

CDIC is a Crown corporation designated in the CDIC Act as the resolution authority for its member institutions. CDIC has the ability to resolve a non-viable FI through a number of resolution tools described below.

In keeping with the FSB Key Attributes, resolution actions under the CDIC Act can and are intended to be taken before the FI is balance sheet insolvent. Where the Superintendent of Financial Institutions (the “Superintendent”) is of the opinion that a FI has ceased, or is about to cease, to be viable and the viability of the FI cannot be restored or preserved by the exercise of the Superintendent’s powers, the Superintendent must report on that to CDIC. CDIC may request the Minister of Finance (the “Minister”) to recommend, if he or she is of the opinion that it is in the public interest to do so, one or more orders (a “Resolution Order”) under the CDIC Act to the Governor in Council (i.e. federal cabinet) for the orderly resolution of the non-viable FI.

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<sup>1</sup> This note has been developed following amendments made to CDIC Act by the Budget Implementation Act, 2017, No. 2, which came into force on December 14, 2017. It does not constitute legal advice. It is intended as a general summary of the current legislative framework and the process of resolution.

<sup>2</sup> EFCs include derivatives, swaps, repurchase agreements and similar contracts. See definition of EFCs in Eligible Financial Contract Regulations (CDIC Act), SOR/2007-255, as amended.

<sup>3</sup> See paragraphs (a), (b) and (f) of subsection 39.15(7) of the CDIC Act.

On the recommendation of the Minister, the Governor in Council may decide whether a Resolution Order should be made and, if so, which Resolution Order(s) to make. The Governor in Council may make one or more of the following Resolution Orders:

- a) vest in CDIC the shares and subordinated debt of the FI that are specified in the order;
- b) appoint CDIC as receiver in respect of the FI;
- c) direct the Minister to incorporate a federal institution designated in the order as a bridge institution and specify the date and time as of which the FI's deposit liabilities are assumed;  
or,
- d) direct CDIC to carry out a conversion, in whole or in part – by means of a transaction or series of transactions and in one or more steps – of the FI's shares and liabilities that are prescribed by the regulations<sup>4</sup> into common shares of the FI or of any of its affiliates (i.e. bail-in).

The resolution tools available to CDIC will be determined by the Resolution Order(s). Consequently, through the Resolution Order(s) and public communications, it would be clear to market participants at the outset of the resolution which - or what combination of - resolution tools and accompanying stabilization measures would be pursued in respect of the FI.

## Resolution Stays of Close-Out Rights

Generally, where a Resolution Order is made, counterparties to a FI's agreements are prohibited from terminating or amending their agreements for a number of resolution-related reasons, such as the insolvency or deteriorated financial condition of the FI, non-monetary default by the FI before the Resolution Order was made, a monetary default by the FI before the Resolution Order that is remedied within 60 days after the day of the order, or the making of the Resolution Order.

The CDIC Act provides a 'safe harbour' for EFCs from these general stay provisions, similar to the 'safe harbour' under Canadian insolvency laws, with certain limits discussed below. On the one hand, it is recognized that the legal enforceability of Close-Out Rights under EFCs promotes and contributes to the stability of the Canadian financial system. On the other hand, mass termination or acceleration of EFCs in the context of the resolution of a FI could result in a disorderly rush for the exits that creates further market instability and frustrates the implementation of resolution tools. Accordingly, the CDIC Act places certain limits on the exercise of Close-Out Rights when a Resolution Order is made, in keeping with the FSB Key Attributes.

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<sup>4</sup> As at the date of this Guidance, the 'bail-in' regulations have not yet been enacted by the Governor in Council.

## No Stay

As a starting point, it is important to note that certain rights of EFC counterparties are not affected by the stays. Where a Resolution Order is made, EFC counterparties can exercise remedies for a failure to satisfy an obligation under or in connection with the EFCs, including payment or delivery obligations. They can deal with financial collateral to satisfy any payment, delivery or settlement obligations. They can also exercise netting or set-off rights under or in connection with the EFCs (except as may be limited as a result of the resolution stays discussed below). EFC counterparties can exercise any other Close-Out Rights unless they are stayed for reasons covered by the resolution stays discussed below.

## Resolution Stays

Where a Resolution Order is made, EFC counterparties<sup>5</sup> would be stayed from exercising Close-Out Rights *by reason only of the following*:

- the insolvency or deteriorated financial condition of the FI, any of its affiliates or credit support providers or guarantors (the “Insolvency/DFC”)
- the making of a Resolution Order or any change of control or ownership of the FI or any of its affiliates that is related to the making of the order;
- the assignment or assumption of the EFC to or by a bridge institution or a third party;
- a ‘bail-in’ conversion (as discussed under Open Bank Resolution below); and/or,
- a conversion of any of the FI’s shares or liabilities in accordance with their contractual terms (for example, non-viability contingent capital (known as ‘NVCC’) instruments).

The stay for reason only of the Insolvency/DFC (the “Temporary Stay”) ceases to apply automatically at 5:00 p.m. on the second business day after the day on which the Resolution Order was made.<sup>6</sup> After the Temporary Stay ceases to apply, EFC counterparties can rely on the Insolvency/DFC to exercise Close-Out Rights as long as that Insolvency/DFC still exists at the time the Temporary Stay ceases. In their exercise of Close-Out Rights, EFC counterparties are not prevented from pointing to the facts that led to the making of the Resolution Order as evidence of the Insolvency/DFC.

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<sup>5</sup> In respect of a counterparty that is a clearing house acting in that capacity for a FI at the time a Resolution Order is made, the Resolution Stays discussed below do not apply to its EFCs with the FI unless CDIC has given an undertaking to provide the financial assistance the FI needs in order to discharge its obligations to the clearing house as they become due.

<sup>6</sup> There is a limited exception to this in the case of a Bridge Bank Resolution. It is discussed under Bridge Bank Resolution in this guidance note.

However, subject to the discussion below, EFC counterparties would continue to be stayed in resolution from exercising their Close-Out Rights for any of the **other** reasons listed above (collectively, the “Permanent Stay”).

At the time the Temporary Stay ceases to apply, counterparties to EFCs should have confidence that either they will be able to exercise Close-Out Rights for reason of Insolvency/DFC or their EFCs will continue with:

- (1) the FI (their original counterparty), which is restored to financial viability through implementation of the resolution tools and accompanying stabilization measures (see “Open Bank Resolution” below);
- (2) a credit-worthy third party acquirer (see “Forced Sale Resolution” below); or
- (3) a solvent and CDIC supported bridge institution (see “Bridge Bank Resolution” below).

Where CDIC assigns an EFC to a third-party or a bridge bank, the CDIC Act provides for certain creditor safeguards. Specifically, CDIC must assign all of the EFCs outstanding between the FI and the EFC counterparty and its affiliates (i.e. no cherry-picking), and CDIC may only assign an EFC to a third party if that party meets certain conditions, including that, among other things, it is:

- balance sheet solvent;
- able to discharge its obligations under the assigned EFC as they become due; and,
- at least as credit-worthy as the FI was immediately before the Resolution Order was made (taking into account any credit support or guarantee in respect of the obligations under the EFC before and after the assignment, respectively).

Further details of how the Temporary Stay and the Permanent Stay (together, the “Resolution Stays”) would apply to EFCs in the context of Open Bank Resolution, Forced Sale Resolution and Bridge Bank Resolution are outlined below.

## Open Bank Resolution

In 2016, Canada’s resolution tools were expanded by providing CDIC with greater flexibility to resolve a non-viable FI that has been designated as a domestic systemically important bank (“D-SIB”).<sup>7</sup> In addition, a ‘bail-in’ power to convert a D-SIB’s prescribed shares and liabilities was also introduced in 2016, to allow CDIC to effectively recapitalize the FI.

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<sup>7</sup> Accordingly, the Open Bank Resolution tool only applies to FIs that are designated as D-SIBs pursuant to the Bank Act (Canada) by the Superintendent.

In an Open Bank Resolution, CDIC would take temporary control of a non-viable FI, either as shareholder (under a Resolution Order vesting in CDIC shares and subordinated debt of the FI) or as receiver (under a Resolution Order appointing CDIC as receiver in respect of the FI). After a Resolution Order is made, CDIC would stabilize the FI so that the FI can continue its critical functions and return it to viability as quickly as possible.

In general, an EFC would remain an obligation of the FI under CDIC's control throughout an Open Bank Resolution. EFC counterparties would be subject to the Resolution Stays. After the Temporary Stay ceases to apply, EFC counterparties would remain subject to any applicable Permanent Stay.

However, it is expected that immediate actions would be taken to restore confidence in the FI and to maintain the stability of the financial system in Canada. Following the stabilization and any restructuring of the FI that may be necessary, CDIC would return the FI to private control.

## Forced Sale Resolution

Where CDIC considers that a transaction (or a series of transactions) between a non-viable FI and one or more third parties is reasonably likely to be expeditiously carried out, CDIC may 'force' the FI to carry out the transaction.<sup>8</sup> Similar to an Open Bank Resolution, CDIC would take temporary control of the FI, either as shareholder or as receiver.

EFC counterparties would be subject to the Resolution Stays in a Forced Sale Resolution. After the Temporary Stay ceases to apply, EFC counterparties would be able to exercise Close-Out Rights if the EFCs are not transferred from the FI to a credit-worthy third party and the Insolvency/DFC still exists. Otherwise, EFC counterparties would remain subject to any applicable Permanent Stay.

Depending on the circumstances, if CDIC considers that all or substantially all of the FI's assets will be transferred to a third party and that certain EFCs will stay with the non-viable FI, it may decide to give notice to the relevant EFC counterparties and lift the stay so that those EFC counterparties could exercise their Close-Out Rights immediately.<sup>9</sup>

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<sup>8</sup> The Forced Sale resolution tool applies to all FIs.

<sup>9</sup> In this case, EFC counterparties can exercise their Close-Out Rights for reason of the Insolvency/DFC or the making of a Resolution Order starting on the date and time the notice is issued.

## Bridge Bank Resolution

Where the Governor in Council directs the Minister to establish a temporary bridge bank, CDIC has the ability to transfer the non-viable FI's critical functions and viable operations to the bridge bank.<sup>10</sup> CDIC would subsequently transfer the bridge bank or its assets to private ownership or arrange for another exit transaction.

In a Bridge Bank Resolution, CDIC would be appointed as receiver of the non-viable FI and would be the sole shareholder of the bridge bank. CDIC would cause a purchase and assumption transaction to be entered into between the FI and the bridge bank. CDIC is required to provide the financial assistance that the bridge bank needs in order to discharge its payment obligations as they become due.

EFC counterparties would be subject to the Resolution Stays. CDIC may assign EFCs to a bridge bank, provided it adheres to the no 'cherry-picking' rules. Within the Temporary Stay period, CDIC would either complete the transfer of an EFC to the bridge bank or provide an undertaking to transfer it to the bridge bank.

If CDIC provides an undertaking to transfer an EFC to the bridge bank within the Temporary Stay period, such an undertaking would extend the Temporary Stay only until the transfer is completed (the expected date of which would likely be specified in the undertaking). In practice, the transfer would be completed as close to the two business days as possible, in keeping with the expectation in the FSB Key Attributes that the Temporary Stay be strictly limited in time. The Permanent Stay would continue to apply in respect of EFCs that are transferred to the bridge bank.

However, if CDIC does not transfer, or undertake to transfer, an EFC to the bridge bank within two business days, the EFC counterparties could exercise Close-Out Rights immediately after the Temporary Stay ceases to apply.<sup>11</sup>

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<sup>10</sup> The Bridge Bank resolution tool applies to all FIs.

<sup>11</sup> In this case, EFC counterparties can exercise their Close-Out Rights for reason of the Insolvency/DFC or the making of a Resolution Order starting at 5:00 p.m. at the location of CDIC's head office on the second business day after the day on which the Resolution Order is made.