

Guidance on Exercise of Eligible Financial Contracts

Close-out Rights in a Resolution Scenario

This guidance note has been developed by the Canada Deposit Insurance Corporation (CDIC) following amendments made to the *Canada Deposit Insurance Corporation Act* (“CDIC Act”) by the *Budget Implementation Act, 2016, No.1* (“BIA 2016”), which came into force on June 22, 2016.¹

Where an order is made by the Governor in Council (federal cabinet) to allow for the orderly resolution of a non-viable federal financial institution (“FI”) that is a CDIC member (a “Resolution Order”), the CDIC Act suspends the right of a party to rely on the making of the Resolution Order or resolution actions taken pursuant to it as the basis to exercise certain contractual close-out rights in respect of eligible financial contracts (“EFCs”), which include derivatives, swaps, repos, and similar contracts.² In keeping with the Financial Stability Board’s *Key Attributes of Resolution Regimes for Financial Institutions* (the “FSB Key Attributes”), the suspension of such rights is limited to certain circumstances connected to the FI’s non-viability and the exercise of resolution powers. Importantly, the CDIC Act and the making of a Resolution Order or commencement of the resolution steps does not prevent termination, the exercise of netting or set-off rights, or the general realization of financial collateral (“close-out rights”) held by counterparties of an FI *for reasons not related to* the resolution events. While the CDIC Act prevents reliance on “insolvency” as an event of default, it only does so in the event of resolution.³ In addition, counterparties are not stayed, even temporarily, from exercising close-out rights triggered by pre or post-Resolution Order non-performance of payment or delivery obligations.

With the approval of the Governor in Council, CDIC has the ability to resolve a failing member institution through the resolution methods set out below. In keeping with the FSB *Key Attributes*, resolution steps under the CDIC Act can and are intended to be taken before the FI is balance sheet insolvent. On receiving a report from the Superintendent of Financial Institutions that an FI has ceased, or is about to cease, to be viable, CDIC may make a recommendation to the Minister of Finance (the “Minister”), who then may recommend one or more Resolution Orders to the Governor in Council. On the recommendation of the Minister, the Governor in Council then decides whether a Resolution Order should be made and which Resolution Order(s) to make. Consequently, through the Resolution Order and public communications, it would be clear to market participants at the outset of resolution which, or what combination of, tools and accompanying stabilization measures would be pursued.

¹ This note does not constitute legal advice. It is intended as a statement of CDIC’s understanding of the current legislative framework and its general expectations as to the process of resolution.

² See definition of EFCs in *Eligible Financial Contract Regulations* (CDIC Act), SOR/2007-255, as amended.

³ The CDIC Act does not prevent the exercise of close-out rights against an FI on the commencement of formal regular insolvency proceedings, such as liquidation proceedings under the *Winding-up and Restructuring Act* (Canada).

In developing its recommendations on the choice of resolution approach and in executing a resolution, CDIC would be guided by its statutory objects, including promoting and otherwise contributing to the stability of the financial system in Canada, and in so doing by the FSB *Key Attributes*. In this regard, CDIC recognizes that the legal enforceability of close-out rights, including in the event of and by reason of any new or continued insolvency of a FI, also promotes and contributes to the stability of the Canadian financial system and, therefore, any limits that are unrelated to the resolution events on the exercise of close-out rights should be strictly limited in time (e.g., consistent with the FSB *Key Attributes*, for a period that does not substantially exceed two business days). Ongoing insolvency would not exist where there is a high degree of certainty that the crisis will be stabilized expeditiously through implementation of the resolution tools and measures described below. Parties to EFCs with the FI should have, at the time of the making of the Resolution Order, confidence that their transactions will continue in place either with: (1) their original counterparty restored to financial viability through implementation of the institution's previously prepared resolution plan (Open Bank Resolution); (2) a solvent and CDIC supported bridge institution (Bridge Bank Resolution); or (3) a credit worthy third party acquirer (Forced Sale Resolution).

The following outlines some details concerning how EFCs could be addressed in the context of CDIC's various resolution tools, including how the exercise of close-out rights may and may not be affected.

Open Bank Resolution

BIA 2016 expanded Canada's existing resolution tools by providing CDIC with greater flexibility to take temporary control of a failing FI that is a domestic systemically important bank and continue its operations, as receiver or shareholder.⁴ In addition, a "bail-in" power to convert eligible shares and liabilities of a domestic systemically important bank was also introduced as part of BIA 2016, to allow the bank to be effectively recapitalized.⁵ An open bank resolution would be undertaken by CDIC, as a Crown corporation, with the goal of stabilizing the FI (so that it can continue to meet its obligations as necessary) and to return it to viability to maintain financial stability. After a Resolution Order is made, it is expected that immediate actions would be taken to stabilize the FI, in order to restore confidence in the FI.

While under an open bank resolution, all shareholder rights are suspended and CDIC may sell assets and assign liabilities, recapitalize the FI through a conversion of bail-in liabilities, and take other measures as necessary to restructure the FI's operations to restore it to viability. However, CDIC does not have the ability to unilaterally amend or terminate the FI's ongoing contracts, including any EFCs, except as permitted in accordance with their terms.

As noted above, counterparties may exercise any remedies for non-performance of payment and delivery obligations by the FI during an open bank resolution. EFC counterparties would be stayed in a

⁴ Accordingly, the Open Bank resolution tool only applies to CDIC member institutions that are designated as DSIBs pursuant to the *Bank Act* (Canada) by the Superintendent of Financial Institutions.

⁵ The bail-in power is not as yet fully in force, as regulations required to implement it have not yet been enacted by the Governor in Council.

limited way – being prevented from relying on certain resolution events in order to terminate or take certain actions.

An EFC would remain an obligation of the FI under CDIC control throughout the resolution and, subject to the narrow stay triggered by resolution events, would be otherwise enforceable in accordance with its terms. Alternatively, as part of the resolution and depending on the circumstances, CDIC may assign EFCs to a third party without a counterparty's consent, but only if certain creditor safeguards exist with respect to the third party and if all EFCs outstanding between the FI and that counterparty (and its affiliates) are transferred together with any related security interest (i.e. no 'cherry-picking').

For the stay to apply to EFCs between the FI in resolution and designated clearing houses, certain conditions must be met. Specifically, CDIC must provide an undertaking to provide the FI with the financial assistance required to discharge its obligations to the clearing house as they become due.

CDIC works with its member institutions to develop detailed resolution plans, and so would approach a resolution with a high degree of preparedness. As a result, in approving an open bank resolution, it is expected that CDIC, the Minister and the Governor in Council would at the time of making of the Resolution Order have a high degree of confidence that the proposed resolution steps (including recapitalization and measures to allow the FI to continue to meet its obligations) would successfully restore the institution to viability. The narrow stay on EFC counterparties would continue to be in place during the period required to implement the resolution plan in an open bank resolution, as necessary for an ongoing, operating entity. However, the CDIC Act includes the ability for the stay to be lifted at any time by executive order of the Governor in Council where all or substantially all of the FI's assets will immediately or over time be sold to third parties while the FI is still under CDIC temporary control. Since major restructuring sales by CDIC contemplated at the start of, or during, the resolution would require the approval of the Minister, in practice this would likely trigger consideration at the time of the making of the Resolution Order, or during the resolution as necessary, of whether an executive order to lift the stay would be appropriate in the circumstances and in keeping with the FSB Key Attributes.

Bridge Bank Resolution

CDIC has the ability to establish a temporary bridge bank to assume and continue operating critical functions and viable operations of a failed FI.⁶ Under this resolution method, CDIC would be appointed as receiver of the FI and would cause a transaction to be entered into between the FI and the bridge bank. CDIC is required to provide the financial assistance that a bridge bank, a new legal entity, needs in order to discharge its payment obligations, as they become due.

CDIC may assign to a bridge bank any EFCs between the FI and a counterparty, provided it adheres to the no 'cherry-picking' rules. A one-business day stay relating to resolution events would apply in respect of EFCs where a bridge bank order has been made (the FI still having to meet performance obligations). If CDIC undertakes to assign an EFC to the bridge institution before the end of this

⁶ The Bridge Bank resolution tool applies to all CDIC member institutions.

temporary stay (since the transaction may not close in effect before the temporary stay concludes), this stay would be extended with respect to those EFCs. Similar to an open bank resolution, in a bridge bank scenario the narrow stay tied to resolution events would continue to apply to EFC counterparties after being transferred to the bridge bank. If CDIC does not undertake to assign an EFC to a bridge bank, then the EFC counterparty may terminate it in accordance with its terms at the end of the temporary stay.

The one-business day stay would not apply to designated clearing houses, unless CDIC provides an undertaking to provide the financial assistance required by the FI to discharge its obligations to the clearing house as they become due.

Forced Sale Resolution

Similar to a bridge bank resolution, CDIC may be appointed as receiver of the FI or acquire its shares to cause the FI to enter into a transaction with one or more third parties, provided that the transaction is reasonably likely to be entered into expeditiously.⁷ CDIC may assign to a third party EFCs between the FI and a counterparty, subject to creditor safeguards such as adherence by CDIC to the no ‘cherry-picking’ rules.

A narrow stay relating to the resolution events would also apply in respect of EFCs in this scenario, and as above, counterparties would not be stayed in a forced sale resolution for non-performance of ongoing payment and delivery obligations by the FI. Since substantially all of the terms of the transactions would have been negotiated at the time the Resolution Order could be made by the Governor in Council, CDIC anticipates that it would know at that time whether or not the EFCs of a particular counterparty would be transferred to a third party. Similar to an open bank resolution, the Governor in Council may by executive order declare that the stay ceases to apply for EFCs if it considers that all or substantially all of an FI’s assets will be transferred. The narrow stay tied to the resolution events would then continue to apply in respect of an EFC only if CDIC undertakes, before the executive order lifting the stay becomes effective (i.e., within one business day after the Resolution Order) , to assign it to a third party.

The proposed transactions would have to be approved by the Minister and the resolution approach would have to be recommended to the Governor in Council. In practice, the Governor in Council would therefore be able to issue an order that the EFC stay will cease to apply at the end of a one-business day period at the same time as issuing a Resolution Order for CDIC to resolve the failing FI through a forced sale. With the terms of any transaction being substantially negotiated prior to the recommendation to the Governor in Council, the order to lift the stay would, in practice, likely be made in conjunction with the approval of the Resolution Order, meaning that the stay would cease to apply to any EFCs that the third party has not agreed to accept as part of the transaction at the end of the one business day stay period.

⁷ The Forced Sale resolution tool applies to all CDIC member institutions.