Canadian Financial Institution Resolution Stay Powers Getting a Makeover

October 30, 2017

Federal Bill C-63, which received first reading on October 27, 2017, will amend the eligible financial contracts (EFC) stay safe-harbour where a Canadian financial institution is subject to a resolution procedure under the ***Canada Deposit Insurance Corporation Act*** (CDIC Act). The amendments will clarify that the limits that apply to relying on the safe-harbour based on insolvency or deteriorated financial condition are limited to two business days unless effective resolution actions have been taken.

The stay limits will give better effect to the **Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions** (Key Attributes). Netting and credit support opinions will be positively affected by these amendments and the conditions should now exist for development of an ISDA resolution protocol for Canada.

Reasons for the Amendments

To understand the reasons for and the effect of these amendments, some background is useful.

Why the EFC safe-harbour is needed

The special treatment under Canadian insolvency laws (and those of many other countries) for close-out rights under certain types of financial agreements – derivatives, futures, securities financing arrangements, clearing agreements, etc. – is important to reducing systemic risk in global financial markets. This concern for broader economic stability is why the safe-harbours exist even though the exercise of close-out rights can adversely affect the outcome of a particular insolvency proceeding for other creditors.

Dealing with the systemic risk of mass termination

However, mass termination of such financial contracts in the context of the resolution of a domestically systemically important bank could also have a destabilizing effect on a domestic or even the global economy. The Key Attributes recognize that some time-limited restrictions on relying on close-out rights are needed in that case.

The CDIC Act already gives effect to the Key Attributes by imposing certain limits on relying on close-out rights:

- Initially those limits applied only if a bridge institution was to be incorporated. In that situation, CDIC had a short period of time to determine if the EFCs would be transferred to the bridge or not. If not, the stay expired and if CDIC committed to transfer them the stay continued.
- In June 2016 the CDIC Act was amended to bring it more in line with the revised Key Attributes. This involved adding resolution powers (including a power to transfer assets to a third party or conduct a bail-in of new capital) and extending the limit on the stay to apply where these powers were exercised.

Recent clarifications from CDIC and the Government of Canada

As formulated in the 2016 amendments, the limits on the stay were somewhat too open-ended, for two main reasons: (i) they relied in part on the exercise of Cabinet discretion to lift the stay and (ii) they were not entirely clear in their application. Since then, both CDIC and the Government have endeavoured to clarify the requirements:

- To help the industry understand how CDIC intends the provisions to operate, CDIC issued a **Guidance Note** in the fall of 2016 on the treatment of EFCs in the context of resolution.
- The Government committed in the Budget 2017 to introduce amendments to clarify the treatment of and protections for EFCs.

The Bill C-63 amendments are intended to meet the Budget 2017 commitment.

New Lay of the Land

I'm going to cut to the chase and explain how the EFC safe-harbour will work post amendments.

What the counterparty can do in all situations

A counterparty **can** do the following, regardless of which event triggers the rights under the EFC:

- Rely on any pre or post proceeding performance default (e.g. a failure to deliver or pay, a failure to post credit support) to trigger close-out rights. That has not changed. There is not even a temporary stay on reliance on these triggers.
- Deal with financial collateral to satisfy any ongoing or existing payment, delivery or settlement obligations.
    - For example, if there is an unpaid amount, the collateral can be realized to satisfy that amount.
- Exercise netting or set-off rights.
    - Note, however, that because termination is stayed, that right is necessarily circumscribed.
- Take any other close-out actions unless they are triggered solely by the resolution-related events described below.

What the counterparty cannot do, or can do only in certain situations

A counterparty **cannot** rely on certain resolution-related events to trigger termination or acceleration rights or rights to deal with financial collateral. These trigger events include, most notably:

- Insolvency or deteriorated financial condition of the Financial Institution, its credit support providers and its affiliates (**insolvency**).
- The making of the resolution order itself, which would include the appointment of CDIC as receiver or a change of control of the Financial Institution as a result of the order (the **making of the order**).
- Conversion of NVCC or prescribed shares and liabilities (**conversion**).
- Assignment or assumption of the EFC by a third party or bridge institution (**transfers**).

- A counterparty will be able to rely on insolvency after **two business days** as long as that condition still exists
    - For example, conversion may have stabilized the institution over the resolution weekend.

- However, if a bridge institution order is made and CDIC commits to transfer the counterparty's EFCs to the bridge institution the counterparty **cannot** rely on insolvency (or the other listed trigger events)
- On the other hand, if a bridge institution order is made and CDIC does **not** make that commitment within two business days (this was previously one business day), in addition to reliance on insolvency, the counterparty **can** rely on the making of the order
- If the resolution plan is to sell all or substantially all of the assets to a creditworthy third party, but CDIC notifies the counterparty that its EFCs will not be transferred, then the counterparty **can** rely on insolvency and/or the making of the order as of the date of the notice
    - A plan to sell to a third party (as opposed to an actual transfer) will not preclude reliance on insolvency
        - For example, CDIC might provide that notice before the end of the two day stay period so as to allow earlier termination or if termination rights based on insolvency are not exercised at the end of the two day period, it could provide an additional and arguably more certain ground for termination since a counterparty can rely on say, the appointment of CDIC as receiver, as the trigger event.
    - An actual transfer to a third party before insolvency-based termination rights are exercised would preclude termination.

Other clarifications in Bill C-63

The amendments also clarify that while the Act precludes reliance on the making of the order as an event of default, it does not preclude reliance on the facts that led to the making of an order as evidence of insolvency or deteriorated financial condition.