ISDA®

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Canada Deposit Insurance Corporation

Dear Sirs/Mesdames

Re: The *Budget Act 2009* -Amendments to the *Canada Deposit Insurance Corporation Act*

The International Swaps and Derivatives Association (**ISDA**) appreciates this opportunity to make submissions on the amendments made to the *Canada Deposit Insurance Corporation Act* (**CDIC Act**) by the *Budget Act, 2009,* S.C. 2009, c.2. ISDA represents participants in the privately negotiated derivatives industry and is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 800 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. ISDA members include the Canadian chartered banks and major trust companies, as well as many other Canadian entities.

Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business. In that

regard, ISDA recently made recommendations to both Finance Canada and Industry Canada in the process to update the provisions of the *Bankruptcy and Insolvency Act*, the *Winding-up and Restructuring Act*, the *Canada Deposit Insurance Corporation Act*, the *Companies' Creditors Arrangement Act* and the *Payment Clearing and Settlement Act* dealing with eligible financial contracts. Eligible financial contracts (**EFCs**) are a class of contract that includes derivatives contracts, such as interest rate swaps and currency exchange agreements, securities lending agreements, securities repurchase agreements and other types of financial agreements. The purpose of the provisions is to create legal certainty that, in the event of an insolvency proceeding with respect to a Canadian entity, parties to EFCs with the Canadian entity can exercise their contractual right to terminate the EFCs, net the positive and negative exposures under multiple transactions between the parties and exercise their rights against financial collateral securing the obligations under the EFCs (we refer to these as **close-out netting rights**).

The recent amendments made to the Canadian Acts brought Canada up to international banking standards so as to allow regulated financial institutions to deal with Canadian entities on a capital efficient basis and with a reduced level of credit and legal risk. These changes benefited Canadian entities, particularly Canadian financial institutions, allowing them to participate fully and efficiently in these important capital markets.

We have reviewed the amendments to the *Canada Deposit Insurance Corporation Act* (**CDIC Act**) made by the Budget Act as they relate to the assignment or transfer of EFCs to a bridge institution in the context of a receivership of a Canadian insured deposit taking financial institution. There are a few respects in which the amendments could result in regulated institutions no longer having the legal certainty they require with respect to the enforceability of close-out netting rights when dealing with Canadian insured deposit taking financial institutions (**member institutions**). Consequently, regulated institutions will either choose not to deal with the Canadian member institution (because they cannot take on the risk if calculated on a gross basis) or will apply a capital charge in their dealings with a Canadian member institution that will ultimately result in the Canadian member institution obtaining less favourable terms than the member institution's competitors from other jurisdictions would be able to obtain. Effectively this would seriously curtail the ability of the Canadian financial institutions to participate competitively in these important financial markets and would undo much if not all of the benefit of the recent amendments to the CDIC Act with respect to EFCs.

The Prior Law

Under the prior version of the CDIC Act, a Canadian bank that is in financial difficulty could be subject to an order made under section 39.13(1) of the CDIC Act by the federal Cabinet on the recommendation of the Superintendent of Financial Institutions. Upon the making of such an order there is an automatic stay on termination or accelerating payments under contracts by reason only of (i) the federal member institution's insolvency, (ii) a default, before the order was made, by the federal member institution in the performance of its obligations under the agreement, or (iii) the making of the order. However, there is an exemption from this stay with respect to EFCs that allows the institution's counterparty to exercise its contractual close-out nettings rights (the **EFC exemption**).

Proposed Amendments

Part 5, Division 2 of the Budget Act amended the CDIC Act to permit CDIC to assign the EFCs between a member institution subject to a receivership order under the CDIC Act and its counterparty to a bridge institution. If an order directing the incorporation of a bridge institution is made, then the counterparty of the member institution cannot rely on the EFC exemption to close-out its EFCs as long as CDIC undertakes to either guarantee unconditionally the payment of any amount due or that may become due in accordance with the provisions of the EFC by the member institution or ensure that all obligations arising from the EFC will be assumed by the bridge institution. For ease of reference, the relevant proposed section reads as follows:

> (7.1) If an order directing the incorporation of a bridge institution is made, the actions referred to in subsection (7) may not be taken by reason only that the order or an order appointing the Corporation as receiver is made in respect of the federal member institution or that the eligible financial contract is assigned to the bridge institution if the Corporation undertakes to
>
> > (a) unconditionally guarantee the payment of any amount due or that may become due — in accordance with the provisions of the eligible financial contract — by the federal member institution; or
> >
> > (b) ensure that all obligations arising from the eligible financial contract will be assumed by the bridge institution.

Potential Negative Implications

The capital requirements of the Basel Committee on Banking Supervision as set out in *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* dated November 2005 (the Capital Accord)[1], which standards have been adopted internationally, including in Canada with respect to Canadian financial institutions, set out certain criteria that institutions must satisfy in order to be able to net exposures and the value of collateral in calculating their capital requirements with respect to transactions with other entities. In order to calculate such exposures on a net basis, the law protecting close-out netting rights against a counterparty must be certain and robust in certain respects. In assessing legal risk and applying these standards, institutions require that the law in the home jurisdiction (among others) of their counterparty:

> (1) recognize with a high degree of certainty a right to exercise close-out rights in a timely manner in the event of the insolvency of the counterparty,
>
> (2) provide that an insolvency representative cannot choose to perform some of the transactions with a counterparty and reject others if they are subject to a netting or set-off agreement (referred to as "cherry-picking").

As a result of the recent amendments to Canadian insolvency statutes, particularly the *Winding-up and Restructuring Act* (**WURA**) and the restructuring and receivership provisions of the CDIC Act, the prior regime in Canada did provide the required certainty with respect to Canadian financial institutions.

The possibility of assignment of EFCs to a bridge institution where obligations are guaranteed or otherwise credit enhanced by CDIC does not itself preclude a robust legal conclusion as to the enforceability of close-out netting rights as long as the above mentioned principles apply. The similar provisions in Title 12 of the United States Code, §1821 as they relate to the CDIC's U.S. counterpart, the Federal Deposit Insurance Corporation (**FDIC**), for example, provide for a similar regime, albeit allowing assignment to other financial institutions as opposed to a bridge instutition. However, those U.S. provisions are much clearer than the proposed Canadian provisions in ensuring that close-out netting rights are not compromised.

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[1] Found at http://www.bis.org/publ/bcbs118.htm

There are three aspects of the proposed amendments to the CDIC Act that will or could preclude counterparties of a member institution (foreign and domestic) from applying netting for capital calculation, credit assessment or other purposes, with respect to their transactions with CDIC insured financial institutions. First, the new provisions appear to allow CDIC to cherry pick individual transactions and transfer some but not all transactions to the bridge institution. Second, the possibility of a Cabinet order exempting a member institution or bridge institution from any provision of the CDIC Act or WURA (including potentially the EFC exemptions) will create what may be an unacceptable level of legal uncertainty as to the availability of the EFC exemption. Third, the lack of a time limit by which CDIC must decide whether to assign EFCs to the bridge institution may make it difficult for counterparties to conclude that they are able to exercise their rights in a timely fashion. These three issues are explained in more detail below.

Cherry-Picking Risk

The proposed amendments to the CDIC Act suggest that CDIC could cherry-pick transactions. We understand that this was not the intention of the amendment, but a significant ambiguity exists in the legislation because of the way that the term "eligible financial contract" is defined (in the regulations to the CDIC Act). EFCs are defined to include the individual transactions (eg an interest rate swap, a currency exchange contract, etc.) and not only the master agreements with respect to such transactions. Consequently, where the CDIC Act refers to the assignment of the "eligible financial contract" to the bridge institution, read literally, it permits CDIC to transfer individual EFCs even though they are subject to a master agreement that provides for in-the-money transactions to be set-off against out-of-the money transactions. Because of this a counterparty cannot conclude that the exercise of close-out rights with respect to its transactions with the member institution is clearly permitted in the event of an insolvency of a member institution.[2]

The U.S. legislation that applies to assignments of qualified financial contracts by FDIC includes a provision to the effect that FDIC must either assign all such contracts with the member institution or none of them.[3] It is

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[2] To take a simple example, if a counterparty has a transaction with the Canadian member institution that is in the money to the member institution to the tune of $100 million and another transaction with the member institution that is out of the money to the member institution to the turn of $75 million, the net exposure of the counterparty to the member institution is $25 million. However, if CDIC can assign the $100 million transaction to the bridge institution and leave the out of the money transaction with the member institution, the real exposure of the counterparty is $100m and it must calculate its capital requirements on the basis of that gross number, not the net exposure.
[3] 12 USC §1821(9)(A)

very clear under the U.S. Code that there can be no cherry-picking. We believe that an appropriate amendment to the definition of eligible financial contract in the regulations to the CDIC Act could address this issue. However, in the event such a regulation is not passed before the amendments are proclaimed into force and until such a regulation is passed, a written statement from CDIC to the effect that it would only exercise its powers with respect to the assignment of EFCs to a bridge institution by assigning all EFCs between the bridge institution and a particular counterparty would likely provide regulated institutions with sufficient certainty that cherry-picking is not a material concern under Canadian law.

Netting Must Continue to Be Effective Against the Bridge Institution

In order for counterparties to be able to account for EFCs on a net basis with a member institution where those EFCs are potentially subject to transfer to a bridge institution, it must be equally clear that close-out netting is effective against the bridge institution.

Subject to one caveat, this would appear to be the case under the proposed legislation as the bridge institution itself would be the same type of entity as the insolvent member institution (eg a bank, trust company or loan company). Consequently, the bridge institution itself would be subject to the CDIC Act restructuring provisions and *Winding-up and Restructuring Act* (WURA) provisions, including the EFC exemptions in the WURA and CDIC Act. However, new proposed sections 39.131 and 39.3723 create an unacceptable level of uncertainty with respect to the continued availability of the EFC exemption. These provisions allow the Governor in Council by order (section 39.131) or by regulation (section 39.3723) to exempt the bridge institution (and/or the member institution) from any provision in the CDIC Act and WURA. These provisions (particularly section 39.131) on their face allow Cabinet in the context of a particular receivership to remove the EFC exemption since the power to exempt an institution or bridge institution from the application of any provision of these Acts is virtually unrestricted. This possibility seriously undermines the statutory protections for EFCs.

A statement from CDIC to the effect that close-out netting rights would continue to be respected as against any bridge institution that had assumed the obligations under EFCs would likely ameliorate any concern regarding the breadth of these exemptions.

Timeliness of Exercising Remedies

One of the reasons the similar provisions under U.S. law are not an impediment to a positive netting and collateral enforcement analysis is that

FDIC is given only one business day from the date the proceeding commences to determine if it will assign the qualified financial contracts. The ability to exercise remedies on a timely basis is one of the criteria for a positive close-out netting capital and credit analysis.

We understand that it is anticipated that receivership orders and bridge institution orders would be made at or around the same time so that there would in fact not be delays. However, the legislation does not require that the orders be made at or around the same time. Consequently, under the proposed amendments, it appears that CDIC could decide to assign EFCs at any time during the receivership process. There is uncertainty as to how the right to terminate or realize might be affected. For example, if a counterparty terminated prior to CDIC taking the steps contemplated by the new section 39.15(7.1), but had not calculated the close-out amount or realized on any or all of the collateral, it would be in the very difficult position of having irrevocably closed out, but by reason of the stay arising during the process not being able to net or realize on securities with a potentially declining value. A delay of one or two days from the date of the making of the receivership would be consistent with a conclusion that close-out netting rights could be exercised on a timely basis.

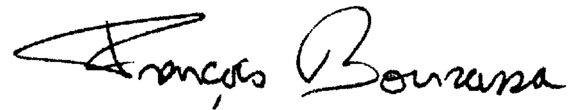
It would again be of assistance to regulated entities, if CDIC could make a statement to the effect that its intention would be that the steps contemplated in section 39.15(7) would be taken simultaneously with or within a period of less than some period of time (say three days) of the making of the receivership order.

Conclusion

If Canadian member institutions are to continue to enjoy the benefits that derive from their counterparties (which in many cases are other Canadian financial institutions) being able to net the value of transactions and collateral provided by the institution, then it is critical that some clarification of the above matters be provided. Representations by CDIC as to its position with respect to these provisions on which parties could rely would be of great benefit in this regard.

If we can provide any further information or assistance, please do not hesitate to contact the undersigned or our counsel, Margaret Grottenthaler, from Stikeman Elliott LLP.

Yours truly,



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