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Basel Committee on Banking Supervision -
Board of the International Organization of Securities Commissions
Cardano Risk Management B.V.

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Response to the Consultative Document 'Margin requirements for non-centrally-cleared derivatives'

Introduction to Cardano

Cardano Risk Management B.V. ('Cardano') provides innovative risk management solutions to institutional clients to help them achieve their strategic financial objectives. Our clients are predominately European pension funds and insurance companies. We frequently execute OTC derivative trades on behalf of clients to assist with the mitigation of risks that are inherent to their liability structure. Annually, Cardano executes on an agency basis around €80-90 billion in interest rate, inflation, equity derivatives and foreign exchange derivatives.

General comments on the Consultative Document

Cardano is pleased to have had the opportunity to contribute to the consultative process. Our objective is to work with regulators to achieve the objectives of increased stability and transparency of derivatives markets such that derivatives remain an cost effective tool for prudent financial risk management. Our input is focused on achieving the right cost/benefit balance between the goals set by the G20 and protecting the financial security of stakeholders such as pensioners. Before answering your questions we want to take the opportunity to make some general remarks in relation to the current developments in the regulation of OTC derivative contracts.

The general objectives of the new regulation and the desire for increased stability and transparency of the financial markets are legitimate, but we are concerned about how it is achieved and what the effects are on our clients that use OTC derivative contracts as risk mitigating instruments.

The proposal outlines two objectives for margining of non-centrally cleared derivatives, i.e. the reduction of systemic risk and the promotion of central clearing. We are concerned that the proposal does not fully describe the criteria that will be used to measure whether these objectives are achieved. With respect to the reduction of systemic risk we would argue that the exchange of variation margin is the most cost effective way to manage counterparty credit risk and to reduce systemic risk. For pension funds we believe that the marginal reduction of credit risk and therefore the marginal reduction of systemic risk achieved by exchanging initial margin (also considering the need to legally segregate initial margin), does not justify the significant negative liquidity impact such initial margin requirements would systemically impose.

With respect to the promotion of central clearing we are concerned that regulators are insufficiently transparent in how they envisage the functioning of the non-cleared derivatives

market in the future. Many types of derivatives that are actively used for risk management purposes are proving very difficult to clear, for example inflation derivatives. If margin requirements for non-cleared derivatives are overly punitive then there is a concern that such derivatives will never become sufficiently mature or liquid to quality for clearing and worse case, cease to exist. If it is indeed the intention of regulators to create an environment where the use of non-cleared derivatives is discouraged at all cost then this should be clearly communicated. This will allow markets and end-users to better prepare for such a new paradigm aiding a smoother (yet not less painful) transition. In our view discouraging the use of OTC derivatives for the purposes of exercising sound risk management is undesirable.

We are of the opinion that if initial margin requirements are established for non-centrally-cleared derivatives then these should be established on a risk based approach that reflects the credit worthiness of an entity. We feel that the applicability of initial margin requirements needs to be fair and consistent when determining which types of institutions contribute to systemic risk and which end stakeholders should pay for the reduction in systemic risk. Under the IORP Directive, European pension funds are restricted in their use of derivatives to solely for the purposes of managing the risk inherent in their pension obligations. Most pension funds exchange daily/weekly variation margin with a diversified group of bank counterparties. Additional initial margin requirements for non-cleared derivatives will require pension funds to invest in a higher amount of high quality assets as well as substantially invest in additional collateral management infrastructure. Collateral scarcity is expected to negatively impact returns on high quality assets. The drag on investment returns resulting from the need to post initial margin will effectively result in lower pensions and therefore we believe that the costs related to exchanging initial margin are not justifiable relative to the benefits achieved for pensioners. Given the non-leveraged nature of pension funds combined with their prudent regulatory framework, we advocate a complete exemption for pension funds of the initial margin rules proposed in the Consultative Document so that the creditworthiness of pension schemes is fully reflected. We support the principals of daily/weekly exchange of variation margin.

From an implementation perspective it should not be so that initial margin requirements result in an increase of counterparty credit risk. For this reason we support the principle that collateral posted as initial margin is not subject to rehypothecation and is held in a sufficiently bankruptcy remote manner. We are concerned about the extent current local insolvency laws provide legal certainty in relation to the segregation of collateral and propose that other models such as pledging of assets are considered. The current proposal considers in our view insufficiently how a robust and transparent operating framework for the exchange of initial margin is maintained. Specifically we question the ability of each local regulatory to approve initial margin models for each asset class and to what extent this avoids regulatory arbitrage. In addition to this we do not understand how the exchange of initial margin will be transparent to the regulator and the involved counterparties if the applied initial margin models can result in the different margin calls for the same portfolio. We recommend that the Working Group also establishes clear objectives and vision around the operational framework of initial margining requirements for non-cleared derivatives.

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Detailed response on the questions

Q1. What is an appropriate phase-in period for the implementation of margining requirements on non-centrally-cleared derivatives? Can the implementation timeline be set independently from other related regulatory initiatives (eg central clearing mandates) or should they be coordinated? If coordination is desirable, how should this be achieved?

We have two main concerns regarding the phasing-in of margining requirements. Firstly we are concerned that the requirements for non-cleared trades that are proposed are overly burdensome and that if they are implemented at the same time as clearing becomes obligatory then this will not incentivise clearing but will actually prevent it. Rationale is that many OTC derivative types are very effective in their use but currently not clearing eligible. Dealers are still in discussion with central clearing parties on which types of derivatives can become clearing eligible. Our concern is that the high cost and burden of applying bilateral initial margining on all market participants will incentivise many participants to stop using such products. This in turn would negatively impact the market liquidity of such products and will effectively make it impossible for such instruments to ever meet clearing requirements.

Our second concern is the timeframe in which operational infrastructure changes need to be made. In general we are concerned that, within a short implementation timeframe, there is insufficient knowledge, infrastructure & service providers and clarity in insolvency laws to effectively support the segregation of initial margin in all jurisdictions for all market participants. The appropriate length for phase-in periods needed for changes in the setup of operations typically depend on the current infrastructure and is thus user specific. Most market participants will have to make substantial investments in both infrastructure as well as staff education. Assuming a firm has existing daily variation margining in place for each ISDA/CSA relationship then (considering that the process for initial margin is a separate but similarly intense process) the collateral management staff would need to be doubled. This is purely the estimated impact on daily operations staff and excludes other staff that may be required to manage collateral availability and liquidity. This further ignores additional operational staff (and training) that is required to support mandatory clearing and reporting.

We strongly recommend that a requirement for initial margining of bilateral trades is implemented *only* after the market has adopted mandatory clearing of derivatives and that a sufficient amount of uncleared derivatives types that currently in the pipeline to become clearing eligible, actually become cleared. Only then will the true impact of clearing on operations, liquidity, systemic risk, etc be known and will these significant changes to the derivative market be manageable for users. In this way lessons can be learned from the effectiveness of the central clearing obligation and the true need for a 'stick' to incentivise clearing is known.

Q2. Should foreign exchange swaps and forwards with a maturity of less than a specified tenor such as one month or one year be exempted from margining requirements due to their risk profile, market infrastructure, or other factors? Are there any other arguments to support an exemption for foreign exchange swaps and forwards?

Foreign exchange forwards and swaps ('FX contracts') are instruments that can give rise to credit exposures from one party to another. Even though a FX contract involves mutual obligations, an 'a-symmetric' value of the contract can build up creating an exposure from one party to the other. The amount of potential credit risk is related to the underlying

volatility of the currency as well as the tenor of the instrument. From this perspective there is thus no reason to exclude these instruments in setting up credit risk management techniques.

Q3. Are there additional specific product exemptions, or criteria for determining such exemptions, that should be considered? How would such exemptions or criteria be consistent with the overall goal of limiting systemic risk and not providing incentives for regulatory arbitrage?

The source of credit risk should not influence the credit risk management process. If the general consensus is that risk mitigation techniques are required and that the amount of acceptable credit risk is zero for all participants then there should be no product specific exemptions. In our view exemptions should be user specific rather than product specific, established on the basis of the risk characteristics of the user rather than the product's.

Q4. Is the proposed key principle and proposed requirement for scope of applicability appropriate? Does it appropriately balance the policy goals of reducing systemic risk, promoting central clearing, and limiting liquidity impact? Are there any specific adjustments that would more appropriately balance these goals? Does the proposal pose or exacerbate systemic risks? Are there any logistical or operational considerations that would make the proposal problematic or unworkable?

We support the goals of reducing systemic risk and promoting central clearing, however we feel that more distinction is required in the application of obligations to justify the cost/benefit of achieving the goals. Specifically we do not believe that the term 'financial entity' is sufficiently granular to distinguish between those entities that are systemically risky themselves and those that contribute to systemic risk due to their use of derivatives. We recommend that more consideration is given to how OTC derivatives are used (i.e. risk increasing versus hedging), the financial leverage and systemic importance of the user and number of derivatives used. This can be achieved by grouping market participants into various categories of riskiness instead of having a participant specific approach (e.g. differentiate between pension funds and hedge funds but not between two specific pension funds).

Pensions funds are similar to non-financial entities in that they require OTC derivatives for cash flow hedging purposes. Pension funds are prudentially regulated and not leveraged and most pension funds exchange daily variation margin with a diversified group of bank counterparties. Smaller pension funds generally execute only a handful of derivatives transactions so that the amount of infrastructure needed to be compliant with the proposed regulation will likely force them to stop using OTC derivatives altogether. If the applicability does not appropriately distinguish between large users of derivatives and smaller users, then we foresee that many smaller financial entities will stop hedging and take on more financial risk, creating more financial instability for its end stakeholders. Another consequence of higher infrastructure costs will be that the barriers for entry to the investment industry will rise and consolidation will occur, creating more systemically large institutions that are too big to fail.

Currently the exchange of variation margin is widely accepted and cost effective means of mitigating counterparty credit risk and there is sufficient market standardisation in theses operational processes. There is however at this moment no market standard practices for the

two-way exchange of initial margin on a segregated basis. In our opinion the proposal provides insufficient clarity about which market participants would be deemed responsible for controlling the daily calculation of initial margin, performing the market valuation of posted collateral and determining the acceptability of posted collateral subject to specific collateral criteria/haircuts. We are concerned about the fact that the current proposal enables each market participant to define its own initial margin model. This creates difficulties for market participants to control the initial margin calculations of counterparties and differences will arise in the initial margin calculations for the same portfolio of derivatives transactions. We strongly believe that this is conflicting with the objective to create more transparency in the financial markets and a reduction of systemic risk. In addition we do not believe local regulators will be capable of performing its tasks on approving models and ensuring compliance to bilateral initial margin requirements. There is a strong likelihood that regulatory arbitrage will occur in terms of initial margin models being approved in different jurisdictions. If (still) initial margin would be introduced, we recommend that a standardised approach is taken to initial margin models and more specific guidance is provided on the operational and logistical aspects to ensure regulatory compliance and a level playing field.

In the current structure there is a substantial difference between sell and buy participants in the liquidity management experience and tools available to effectively manage initial an variation margin collateral requirements. Specifically banks/broker-dealers have access to central banks as a means of mitigating contingent liquidity risk while other end users of derivatives do not. To the extent that more buy side participants are required to post margin, consideration should be given to what extent such entities should also be granted access to central bank funding when repo markets or bank financing is unavailable. This would help to reduce the increased liquidity risk stemming from any additional margin.

Q5. Are initial margin thresholds an appropriate tool for managing the liquidity impact of the proposed requirements? What level of initial margin threshold(s) would be effective in managing liquidity costs while, at the same time, not resulting in an unacceptable level of systemic risk or inconsistency with central clearing mandates? Is the use of thresholds inconsistent with the underlying goals of the margin requirements? Would the use of thresholds result in a significant amount of regulatory arbitrage or avoidance? If so, are there steps that can be taken to prevent or limit this possibility?

We are uncertain about the use of initial margin thresholds in terms of effectiveness in managing liquidity costs and limiting systemic risk. We feel that systemic risk will not be reduced by applying initial margin requirements to bilateral trades instead systemic risk will only be transformed from systemic credit risk to systemic liquidity risk.

Here we would like to distinguish between single purpose liquidity and multiple purpose liquidity. If initial margin is exchanged and fully segregated, it is by definition ring fenced and only released in the event of default of the entity. As a consequence this liquidity will not be available to prevent the default of the entity under other periods of (short term) financial stress. For this reason we remain concerned about the liquidity impact of the proposed requirements for the industry as a whole and the net effectiveness of reducing systemic risk.

Q6. Is it appropriate for initial margin thresholds to differ across entities that are subject to the requirements? If so, what specific triggers would be used to determine if a smaller or zero threshold should apply to certain parties to a non-centrally-cleared derivative? Would

the use of thresholds result in an unlevel playing field among market participants? Should the systemic risk posed by an entity be considered a primary factor? What other factors should also be considered? Can an entity's systemic risk level be meaningfully measured in a transparent fashion? Can systemic risk be measured or proxied by an entity's status in certain regulatory schemes, eg G-SIFIs, or by the level of an entity's non-centrally-cleared derivatives activities? Could data on an entity's derivative activities (eg notional amounts outstanding) be used to effectively determine an entity's systemic risk level?

To help ensure a level playing field among market participants we are of the opinion that initial margin requirements should be established on a risk based approach reflecting the credit risk an entity represents. However, as mentioned in our response to Q4, such an assessment on an entity by entity basis will be intensive. Therefore we feel that it is appropriate to use thresholds as a means to distinguish between the credit riskiness of different types of entities. Thresholds can be defined with a set of simple criteria such as type of entity. It should not be the case that more leveraged and thus by definition higher credit risk entities should have a higher threshold than non-leveraged entities such as pensions funds.

Under IORP Directive, European pension funds are restricted in their use of derivatives to the sole purpose of managing the risk inherent in their pension obligations. Given the non-leveraged nature of pension funds combined with their prudent regulatory framework, we feel that the threshold for such entities should be such that no initial margin should be posted for non-cleared derivatives. The majority of the pension funds that use OTC derivatives have ISDA/CSA's in place that govern the transfer of variation margin to cover for the current credit risk exposure of their OTC derivatives. The marginal reduction in credit risk that comes with the additional posting of initial margin does not justify the associated costs and drag on investment returns. As such we advocate a complete exemption for pension funds of the initial margin rules proposed in the Consultative Document to reflect the creditworthiness of pension schemes.

Q7. Is it appropriate to limit the use of initial margin thresholds to entities that are prudentially regulated, ie those that are subject to specific regulatory capital requirements and direct supervision? Are there other entities that should be considered together with prudentially-regulated entities? If so, what are they and on what basis should they be considered together with prudentially-regulated entities?

The fact that a firm is prudentially regulated is not in itself a measure of credit worthiness or systemic importance. There is no evidence that regulated entities have a lower risk of default. We prefer that criteria should be sufficiently risk based and that in doing so risk elements such as an entities' financial leverage, the underlying use of derivatives, etc are taken into consideration. For example both banks and a pension funds are prudentially regulated however banks are deemed to be of considerably higher credit risk. A further distinction should be made between systemically important entities and not systemically important entities. See also our answer to Q4.

We believe that thresholds should reflect the cost / benefit of initial margin. There are many market participants that are systemically irrelevant and have a relatively small amount of OTC derivatives outstanding. High capital costs on non-cleared OTC derivatives will make them less attractive creating a sufficient incentive for clearing. However many small (buy and hold) users of derivatives are considered undesirable clients by clearing member banks. Also

the cost of clearing for small users of derivatives is relatively excessive due the minimum amount of infrastructure required. If it is an objectives of the EMIR regulation is to prevent (smaller) entities from trading derivatives on a bilateral basis altogether they should be transparent about this and stipulate this as a regulatory objective. It should be noted however that the exchange traded derivatives market does not provide effective alternatives to the OTC market for risk mitigation purposes.

Q8. How should thresholds be evaluated and specified? Should thresholds be evaluated relative to the initial margin requirement of an approved internal or third party model or should they be evaluated with respect to simpler and more transparent measures, such as the proposed standardised initial margin amounts? Are there other methods for evaluating thresholds that should be considered? If so what are they and how would they work in practice?

We foresee a logistical problem with respect to the creation, approval and maintenance of product specific initial margin calculation models. We do not feel that it is efficient from an industry perspective, nor desirable from a regulatory arbitrage perspective, to have each local regulator approve entity specific initial margin models per product type. A more efficient, market consistent and regulatory transparent approach would be to have ESMA publish a centrally approved set of initial margin models that both local regulators and industry participants could access. It is not realistic to expect entities or regulators to ensure that sufficient margin has been posted if the calculations are not market transparent. We also question the ability to have independent 3rd party/tri-party solutions if each counterparty to a portfolio has a different calculation approach to initial margin.

In the central clearing space, central counterparties publish their margin models and all participants are subject to the same initial margin calculation. This makes central clearing margining transparent. The regulators must be clear in their objectives for transparency when it comes to initial margin calculations in the bilateral space. This is because a lack of transparency in margin requirements will immediate result in a lack of transparency in the market prices of derivatives. We do not support the standardised approach as we are concerned that smaller firms, that have insufficient quantitative resources will be disadvantaged from an initial margin perspective while these are by definition of less systemic relevance. We believe that ESMA has the responsibility for supporting a level playing field enabling all parties to meet regulatory requirements.

Q9. What are the potential practical effects of requiring universal two-way margin on the capital and liquidity position, or the financial health generally, of market participants, such as key market participants, prudentially-regulated entities and non-prudentially regulated entities? How would universal two-way margining alter current market practices and conventions with respect to collateralising credit exposures arising from OTC derivatives? Are there practical or operational issues with respect to universal two-way margining?

We expect that a requirement for posting of initial margin in relation to OTC derivatives will negatively impact the financial health of pension funds that use OTC derivatives as a means of practicing sound risk management. Those having low scale risk management practices may choose to stop using derivatives and subject stakeholders to more instability in terms of investment outcomes. The financial consequences of not hedging are mostly felt in tail risk events such as a sudden and large drop in asset values. It is very difficult for pension funds to

financially recover from such events. OTC derivatives are currently the most effective way to hedge such events. As such we believe that discouraging pension funds from using OTC derivatives is undesirable.

The requirement to post initial margin will by definition change the composition of the investment portfolio which in turn will result in lower net asset returns and lower pensions. Pensions funds tend to naturally hold an amount of high quality collateral assets and these are currently used to meet variation margin requirements in bilateral agreements. Given the contingent liquidity nature of variation margin, the assets held as collateral must be high quality either to transform into cash via the repo market for meeting margin calls from the central clearing house or for delivery into bilateral CSA requirements. The collateral required for initial margin will be by definition be in addition to that allocated for variation margin.

Given that the supply of such high quality collateral assets will most likely be scarce, the return on such assets will by definition continue to be suppressed. The financial consequences of lower asset returns in combination with holding a higher amount of such assets will materially impact the financial health of pension funds. This was one of the key reasons why pension funds requested to be exempt from the central clearing obligation under EMIR. The financial consequences are such that not only less indexation for pensioners will be achieved but also more uncertainty regarding the availability of sufficient funds to meet pension obligations. This will also have substantial and global impact on the economy.

Q10. What are the potential practical effects of requiring regulated entities (such as securities firms or banks) to post initial margin to unregulated counterparties in a non-centrally-cleared derivative transaction? Does this specific requirement reduce, create, or exacerbate systemic risks? Are there any logistical or operational considerations that would make the proposal problematic or unworkable?

As long as collateral is fully segregated and the insolvency laws of the specific jurisdiction provide legal certainty in the segregation of collateral then there should be no reason why regulated entities cannot post initial margin for non-cleared transactions entered into with unregulated counterparties. In our view such a rule would reduce systemic risk given for example the systemic importance of banks.

Q11. Are the proposed exemptions from the margin requirements for non-financial entities that are not systemically important, sovereigns, and/or central banks appropriate?

Non systemically important entities (like pension funds), sovereigns and central banks should be exempt from initial margin requirements for non-centrally-cleared derivatives. The economic costs of implementing certain margin requirements for sovereigns and central banks will by definition be passed on to taxpayers. Given that sovereigns and central banks are low risk from a credit risk perspective, the costs of clearing do not justify the benefits to end stakeholders and for that reason we support their exemption. Similarly such costs will be incurred by other less credit risky market participants and be passed on to end stakeholders such as pensioners. We feel that the applicability of initial margin requirements needs to be fair and consistent when determining which types of institutions contribute to systemic risk and which types of end stakeholders should pay for the reduction in systemic risk.

We recommend to also create the possibility for entities to choose to maintain OTC positions without initial margin but with a range of banks managing credit risk via diversification and where appropriate, the daily exchange of variation margin.

Q12. Are there any specific exemptions that would not compromise the goal of reducing systemic risk and promoting central clearing that should be considered? If so, what would be the specific exemptions and why should they be considered?

We assume that exemptions shall be relative to size and related to risk contribution or riskiness on classes of entities. It should not be so that leveraged, high risk entities are exempt while low risk, non-leveraged entities are not. Nor should small users of derivatives be expected to invest in substantial infrastructure when the cost involved is too high relative to the risk that would be hedged via OTC derivatives. We recommend that legislators focus on the major swap participants using trade repository data to identify these.

Q13. Are the proposed methodologies for calculating initial margin appropriate and practicable? With respect to internal models in particular, are the proposed parameters and prerequisite conditions appropriate? If not, what approach to the calculation of baseline initial margin would be preferable and practicable, and why?

In determining the initial margin requirements we agree to the non-switching possibility: once chosen for a certain approach (i.e. model or standard form) a party should not be permitted to switch approach back and forth whenever deemed favorable. In terms of the model based approach we call for full disclosure of the model, assumptions and inputs used as a means of being able to control if sufficient margin has been posted.

The rules suggested for determining baseline initial margin do not necessarily create a level playing field with cleared trades. Some of the basic principles in determining the initial margin amount differ.

- For example, we consider the 10 day close out period as too conservative. In the cleared space, LCH for example accounts for a 5 day close out period. For end-users, who are granted a 2 day portability window, this translates into a 7 day close out period.

- Lengthening the close out period results in higher initial margin requirements and a higher drain on market liquidity

- In general it is easier to close out derivatives in the non-cleared environment than in the cleared environment and this was proven in the default of Lehman Brothers.

In addition to this we feel the need to express our concerns about the overall liquidity impact the proposal might have. The chosen methodology seems to point to an overly conservative approach in determining the initial margin: conservative close out periods, the absence of diversification benefits across asset classes, the pre-requisite for initial margin models to be calibrated over a periods of financial stress together with the lack of multilateral netting opportunities inherent in bilateral space (as opposed to clearing) all point to a substantial negative impact on overall liquidity.

Q14. Should the model-based initial margin calculations restrict diversification benefits to be operative within broad asset classes and not across such classes as discussed above? If not, what mitigants can be used to effectively deal with the concerns that have been raised?

We consider the proposed approach of not acknowledging any diversification benefits across asset classes as too conservative which results in unnecessarily high collateral needs. We recommend that this point is taken into account when defining asset classes to enable appropriate netting.

Q15. With respect to the standardised schedule, are the parameters and methodologies appropriate? Are the initial margin levels prescribed in the proposed standardised schedule appropriately calibrated? Are they appropriately risk sensitive? Are there additional dimensions of risk that could be considered for inclusion in the schedule on a systematic basis?

We consider the proposed standardised schedule to be insufficiently calibrated with models that are currently used in the clearing space or other similar available models which in our view contradicts with the aim of creating a level playing field.

One advantage of a standardised schedule is the operational and regulatory transparency in managing and controlling initial margin requirements. These benefits can only be achieved if all participants utilise the same initial margin calculation per asset class. The regulatory objectives need to be clearly communicated in terms of achieving mathematical correctness of models versus operational/logistical effectiveness and regulatory transparency. If the objective is the latter then we consider the current standardised schedule to be insufficiently granular in terms of maturities and underlying asset types. To achieve operational/logistical effectiveness and regulatory transparency we suggest that the standardised schedule be calibrated with market models and involve simple formulas instead of absolute amounts. Another approach is to have ESMA approved models for each asset class which are accessible for market participants.

Q16. Are the proposed methodologies for calculating variation margin appropriate? If not, what approach to the calculation of baseline variation margin would be preferable, and why?

We support the proposed methodologies for calculating variation margin.

Q17. With what frequency should variation margin payments be required? Is it acceptable or desirable to allow for less frequent posting of variation margin, subject to a corresponding increase in the assumed close out horizon that is used for the purposes of calculating initial margin?

Daily exchange of variation margin is the most effective in terms of mitigating credit risk. However for smaller parties the operational effort involved with daily margining can be taxing. Weekly exchange of collateral management is considered to be a market acceptable solution to ensure that smaller entities can operationally manage variation margin calls on a cost effective basis. Additionally, if parties need to finance the margin calls via the same

bank as where initial margin is be posted, then posting variation margin becomes ineffective in mitigating credit risk.

Q18. Is the proposed framework for variation margin appropriately calibrated to prevent unintended procyclical effects in conditions of market stress? Are discrete calls for additional initial margin due to "cliff-edge" triggers sufficiently discouraged?

We do not feel it is possible to calibrate variation margin to prevent all unintended procyclical effects in conditions of market stress. The obligation to post variation margin is by definition a contingent liquidity obligation. If an entity has inefficient liquidity management expertise or has insufficient liquid assets/borrowing lines then by definition large unexpected directional market movements will place stress on an organisation's ability to meet variation margin requirements. Given that regulators do not have full insight into the liquidity management infrastructure/expertise of all market participants it is difficult to concluded how markets will be effected in time of stress. Therefore we maintain that central clearing merely alters the form of systemic risk from future at default credit risk to daily liquidity risk.

As mentioned in our response to Q4, regulators should consider granting pension funds and other end user entities access to central bank funding in times of market stress as a means of mitigating systemic liquidity risk.

Q19. What level of minimum transfer amount effectively mitigates operational risk and burden while not allowing for a significant build-up of uncollateralised exposure?

Minimum transfer amounts are by definition a balance between operational risk and credit risk and are usually defined per entity based on the perceived credit risk of the entity. Many existing CSAs have rating dependent minimum transfer amount definitions to ensure that this trade-off is well managed when entering into a ISDA/CSA relationship.

If the views in the market with this regard are ignored and pension fund are deemed to exchange initial margin, we recommend that higher minimum transfer amounts are acceptable in relation to these parties as a means of decreasing the operational burden for small market movements.

Q20. Is the scope of proposed eligible collateral appropriate? If not, what alternative approach to eligible collateral would be preferable, and why?

Acceptable collateral for both variation and initial margin is something that is negotiated on a ISDA/CSA specific basis and even though broader classes of collateral may be deemed acceptable from a regulatory perspective, it may not acceptable under a specific contract. All derivative pricing models of derivatives make a financing assumption about underlying collateral acceptable for variation margin. The quality of collateral and the liquidity in the repo market influence the pricing of a derivatives. For example, the lesser the quality of collateral, the less transparent the derivative pricing is. We remain concerned that regardless of what collateral is deemed acceptable by the regulator, banks are pushing market participants into cash only collateral so that banks do not need to finance mismatches in collateral type received in bilateral markets and collateral type paid into cleared markets.

Also of importance is the delivery cycles of different types of collateral. Bonds are minimum T+1 delivery and are subject to custodian/Euroclear etc. cut-offs times. It needs to be clear on which time basis margin will be exchanged. We are not in favour of pre-trade exchange of initial margin and same day margining is not possible given current custodian infrastructure.

Q21. Should concrete diversification requirements, such as concentration limits, be included as a condition of collateral eligibility? If so, what types of specific requirements would be effective? Are the standardised haircuts prescribed in the proposed standardised haircut schedule sufficiently conservative? Are they appropriately risk sensitive? Are they appropriate in light of their potential liquidity impact? Are there additional assets that should be considered in the schedule of standardised haircuts?

Collateral haircuts and diversification requirements are effective means to manage collateral liquidation risk. We are of the opinion that haircuts and diversification requirements should be negotiated bi-laterally as this enables a counterparty credit risk specific approach. We also support having downgrade triggers whereby more conservative haircuts are applied if certain events occur. We do not see the benefit of haircuts being proposed by ESMA on a generic basis. It should also be noted that too stringent haircuts results in overcollateralization when the collateral is liquidated in the market at a higher value. This is an important point as there is no legal right of set-off to the overcollaterised amount and therefore it is basically an unnecessary unsecured risk. Therefore it is very important that haircuts while effective, should not be overly prudent.

Important factors to take into account when determining eligible collateral are price volatility (should be relatively low) and market volume/issuance size (should be sufficiently high) to ensure that sufficient value is retrieved upon liquidation under stressed market condition.

Q22. Are the proposed requirements with respect to the treatment of provided margin appropriate? If not, what alternative approach would be preferable, and why? Should the margin requirements provide greater specificity with respect to how margin must be protected? Is the proposed key principle and proposed requirement adequate to protect and preserve the utility of margin as a loss mitigants in all cases?

Unlike variation margin there is no contractual right of set-off for the posting of initial margin with a derivatives counterparty. From a credit risk perspective, posting of initial margin directly to a counterparty is therefore the equivalent of an unsecured loan. For this reason we support the requirement that collateral is fully segregated. This is subject to relevant local insolvency laws that might need amending to provide for legal certainty of segregation. Additionally we prefer a pledging model for initial margin as this most likely provides more certainty from a insolvency law perspective but it is also operationally efficient from a settlement risk perspective. A pledging model can be decentralised using suitable custody banks, or centralised using central banks.

Q23. Is the requirement that initial margin be exchanged on a gross, rather than net basis, appropriate? Would the requirement result in large amounts of initial margin being held by a potentially small number of custodian banks and thus creating concentration risk?

If an initial margin obligation is applicable it can either be exchanged on a one or two-way basis however the least credit worthy entity should contribute the highest amount of initial margin. We are concerned there is only a limited set of custodians that understand collateral management and OTC derivatives and wonder whether there is sufficient knowledge to support the required infrastructure for fully segregated collateral management. For this reason we support a pledged model at a central bank and/or a custodian.

Q24. Should collateral be allowed to be re-hypothecated or re-used by the collecting party? Are there circumstances and conditions, such as requiring the pledgee to segregate the re-hypothecated assets from its proprietary assets and treating the assets as customer assets, and/or ensuring that the insolvency regime provides the pledger with a first priority claim on the assets that are re-hypothecated in the event of a pledgee's bankruptcy, under which re-hypothecation could be permitted without in any way compromising the full integrity and purpose of the key principle? What would be the systemic risk consequences of allowing re-hypothecation or re-use?

Rehypothecation is acceptable for variation margin as there is a legal right of set-off against the market value of the derivative transactions. The posting of initial margin for a portfolio is basically overcollateralisation as by definition is an unsecured risk. From a credit risk management perspective rehypothecation of initial margin should never be acceptable.

Q25. Are the proposed requirements with respect to the treatment of non-centrally-cleared derivatives between affiliated entities appropriate? If not, what alternative approach would be preferable, and why? Would giving local supervisors discretion in determining the initial margin requirements for non-centrally-cleared derivatives between affiliated entities result in international inconsistencies that would lead to regulatory arbitrage and unlevel playing field?

No comment.

Q26. Should an exchange of variation margin between affiliates within the same national jurisdiction be required? What would be the risk, or other, implications of not requiring such an exchange? Are there any additional benefits or costs to not requiring an exchange of variation margin among affiliates within the same national jurisdiction?

No comment.

Q27. Is the proposed approach with respect to the interaction of national regimes in cross-border transactions appropriate? If not, what alternative approach would be preferable, and why?

We believe the proposed approach is appropriate as it ensures consistency.