KarsonCollateral

September 13, 2012

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

International Organization of Securities Commissions
C/ Oquendo 12
28006 Madrid
Spain

Re: Margin requirements for non-centrally-cleared derivatives – Eligible collateral for margin

Ladies and Gentlemen:

The Basel Committee on Banking Supervision ("BCBS") and the Board of the International Organization of Securities Commissions ("IOSCO" and together with BCBS, the "Organizations") have proposed key principles and requirements relating to margin for non-centrally-cleared derivatives (the "Proposed Requirements").[1] The Proposed Requirements suggest a broadening of the scope of eligible collateral to include assets like high quality covered bonds, rather than only the most liquid, highest quality assets, such as cash and high quality sovereign debt. We agree with this suggestion and urge the Organizations to recognize debt issued by purpose-built vehicles as within the suggested broadening.[2]

Karson Collateral ("Karson"), through its affiliates, is an established provider of collateral solutions to the regulated insurance and reinsurance markets. We write to support the Organizations' proposed approach and to ask them to consider instruments like Karson's K-Notes (U.S. patent # 7,769,655) ("K-Notes") as eligible collateral that satisfy the Proposed Requirements.

The Organizations have identified "high quality covered bonds," among other types of assets, as an example of eligible collateral that satisfies the key principles of (i) high liquidity, (ii) the ability to hold value in times of financial stress after accounting for risk-appropriate haircuts to mitigate credit, market and FX risks, and (iii) protection against "wrong way risk," the susceptibility of an asset pool to adverse correlation with a counterparty's credit risk (each a "Key Principle" and together the "Key Principles"). Generally speaking, covered bonds are debt securities that offer dual recourse. Bondholders not only have recourse to the issuer of the bonds, but they also have full, first priority recourse to a "cover pool" of assets that are subject to

[1] The Proposed Requirements are included in the consultative document entitled "Margin requirements for non-centrally-cleared derivatives," issued in July 2012 by the Organizations for comment by September 28, 2012.
[2] The Proposed Requirements allow for additional types of eligible collateral, presumably including such debt, but specific mention by the Organizations will overcome uncertainties that might otherwise impede development.

haircuts. These assets are commonly in the form of mortgage loans or public sector loans, and are in some instances held by a bankruptcy-remote special purpose entity. Thus, from a credit evaluation perspective,[3] the quality of a covered bond depends in large part on the quality of its cover pool, but because of the dual recourse nature of covered bonds, the issuer's creditworthiness is also relevant. Together, both of these factors are a proxy for the ultimate assessment as to the bondholder's probability of recovery in the event of the issuer's default.

Although it is clear that a higher probability of recovery equates to a higher quality covered bond, the Proposed Requirements are not specific with respect to the definition of "high quality covered bonds." Presumably, in jurisdictions with established statutory frameworks in respect of covered bonds,[4] covered bonds satisfying such statutory requirements are implicitly of high quality. However, in jurisdictions where covered bond issuances are non-regulated and contractually-based, the determination of high quality will need more guidance.[5] We therefore ask the Organizations to include in the final requirements guidelines for what constitute "high quality covered bonds," whether or not subject to a statutory program.

K-Notes are fully-secured demand notes and have been approved (or positively opined upon) as a qualifying asset for reserve credit for reinsurance and surplus relief by the Insurance Departments of four U.S. States and the Office of the Superintendent of Financial Institutions in Canada. Since December 2009, US$4.8 billion of K-Note transactions have been concluded. Even without guidance regarding the precise nature of "high quality covered bonds," a K-Note matches our covered bond description and, more importantly, satisfies the Key Principles.

K-Notes are issued by a bankruptcy-remote trust on behalf of a party requesting the issuance of such K-Notes for collateral purposes. Like covered bonds, K-Notes offer more than one means of recourse to their holders. K-Notes are supported by a first lien on a portfolio of readily marketable securities that are subject to standardized haircuts, daily margining, and asset pool adjustment—similar to the "cover pools" of covered bonds. This asset pool of securities from which K-Notes may draw is just as, if not more, liquid than the asset pools of covered bonds, which are generally comprised of loans. In addition, holders of K-Notes have full recourse to not only the K-Note issuer (the "K-Note Sponsor"),[6] but also to two or more

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[3] See, for example, the "Purposes and Procedures Manual" of the National Association of Insurance Commissioners Securities Valuation Office.

[4] In these jurisdictions, the legal frameworks governing the issuance of covered bonds spell out several requirements, such as the type of institutions allowed to issue covered bonds, the types of assets eligible for cover pools, and the priority rights of covered bondholders against such assets in the event of issuer insolvency. FITCH RATINGS, ABCs OF U.S. COVERED BONDS 1, 5 (Sept. 3, 2008).

[5] In the U.S., where no statutory framework for covered bonds exists, the Department of Treasury issued a Best Practices Guide in July 2008 that offers recommended guidelines for the issuance of residential mortgage covered bonds. These guidelines, despite having no effect of law, offer insight into what types of covered bonds are considered high quality. Although other non-statutory jurisdictions may not have similar guidance, the Treasury guide may provide useful general insights.

[6] The K-Note Sponsor will in all cases be guaranteed by the counterparty in question and in many cases guaranteed by a highly rated affiliate or the parent of the counterparty.

independent qualifying financial institutions[7] that assume joint and several unconditional payment obligations in respect of the K-Notes in the event that the counterparty fails to pay and its margined securities (which are subject to a haircut) prove inadequate upon liquidation to satisfy the beneficiary's claim. This is superior to a covered bondholder's recourse to only the issuer of such covered bonds and the covered bond issuer's portfolio of, typically, relatively illiquid loan assets. The K-Note Sponsor and the supporting qualifying financial institutions would be legally obligated to make payment to the noteholder in satisfaction of a demand for redemption no later (following such demand) than the end of a normal settlement cycle for the pledged securities supporting the K-Note.[8]

Reviewing the criteria offered by the Organizations, the unconditional payment obligations of certain qualifying financial institutions, along with the first lien on the pool of marketable securities and rapid settlement, satisfy the first Key Principle of high liquidity. The dual recourse nature of K-Notes, standardized haircuts, daily margining procedures, and the bankruptcy-remote status of the issuer satisfy the second Key Principle of holding value in times of financial stress. The third Key Principle, avoiding adverse correlation, is met by rules requiring that qualifying financial institutions must be unrelated to the client who is required to put up the collateral. For these reasons, we believe that K-Notes satisfy the eligible collateral framework outlined in the Proposed Requirements, and we ask that the Organizations express the eligibility of K-Notes and similar obligations accordingly.

We note that in order to be competitively efficient from the perspective of swap entities, structures like the K-Note program must also bring capital treatment to those entities on par with other types of eligible collateral. We ask the Organizations to consider this issue simultaneously with consideration of the eligibility of K-Notes and other similar obligations.

We would be delighted to have the opportunity to answer any questions that the BCBS or IOSCO may have about the K-Note program. Please contact our counsel, Joshua Cohn or Curtis Doty of Mayer Brown LLP (212-506-2500), to arrange such a discussion.

Yours truly,

Derrell Hendrix

[7] Karson proposes that any of the following be recognized as a qualifying financial institution: an entity authorized by its relevant regulator to undertake the proposed activity that is a bank, as defined in Section 3(a)(6) of the Securities Exchange Act of 1934 (the "Exchange Act"), a banking institution organized under the laws of a non-U.S. jurisdiction that maintains at least US$1 billion of regulatory capital, or an insurance or reinsurance company that is subject to supervision as such by the insurance commission (or similar regulatory authority or agency) of a State of the United States, by the United States or an agency or instrumentality thereof or by a financial services regulatory authority of a G20 member government.

[8] Market participants would, of course, be free to stipulate a shorter payment timeframe, which K-Notes could be structured to accommodate.