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Basel Committee on Banking Supervision
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Subject: Response to the second 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 and foreign exchange derivatives.

General comments on the Consultative Document

Cardano is pleased to have 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 a 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 make some general remarks in relation to the current developments in the regulation of OTC derivative contracts.

With respect to the reduction of systemic risk we 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.

As stated in our response to the first Consultative Document "Margin requirements for non-centrally cleared derivatives" dated 28 September 2012, 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. 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.

We find the phasing in period proposed in this second Consultative Document for the requirement to exchange variation margin unclear in relation to the timetable used in EMIR. EMIR (article 11, part 3)

states that "financial counterparties shall have risk-management procedures that require the timely, accurate and appropriately segregated exchange of collateral with respect to OTC derivative contracts that are entered into on or after *16 August 2012*." The proposed phasing in period in this second consultation requires the exchange of variation margin to become effective on *1 January 2015*. Clarity on this issue should be given as soon as possible such that market participants that are not yet prepared can do so.

With regards to Requirement 3 – Variation margin – we request that the technical standards are explicit with regards to allowable netting sets and "sufficient" frequency. Although the exchange of variation margin under an ISDA/CSA arrangement is an established market practice, daily margining is not yet market practice for all market participants. We recognise the comments in section 3.15 about the complexity of agreeing current exposure amounts of non-centrally cleared derivatives and the need to have robust dispute resolution procedures in place. Market practice is that many such disputes are resolved by agreeing an acceptable amount of model-differentiation and this model differentiation is taken into account when establishing minimum transfer amounts. We recommend a higher minimum transfer amount such as EUR 250.000 instead of the proposed EUR 100.000 to avoid the dispute process being inundated which small modelling differences in complex products. We do not feel that the minimum transfer amount will influence the level playing field between cleared and non-cleared products as many complex derivatives are too customised to ever become clearing eligible.

Detailed response on the questions

Q1. Given the particular characteristics of physically-settled FX forwards and swaps, should they be exempted from initial margin requirements with variation margin required as a result of either supervisory guidance or national regulation? Should physically-settled FX forwards and swaps with different maturities be subject to different treatments?

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. This asymmetric value arises in both physically-settled and non-physically settled FX derivatives. From this perspective there is thus no reason to exclude physically-settled instruments in setting up credit risk management techniques.

Q2. Should re-hypothecation be allowed to finance/hedge customer positions if re-hypothecated customer assets are protected in a manner consistent with the key principle? Specifically, should re-hypothecation be allowed under strict conditions such as (i) collateral can only be re-hypothecated to finance/hedge customer, non-proprietary position; (ii) the pledgee treats re-hypothecated collateral as customer assets; and (iii) the applicable insolvency regime allows customer first priority claim over the pledged collateral.

Re-hypothecation 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 (if any) is by definition over-collateralisation which results in additional credit exposure. From a credit risk management perspective re-hypothecation of initial margin should never be acceptable and we support the principles in the consultation paper of ensuring initial market is sufficiently projected in the event of bankruptcy.

Q3. Are the proposed phase-in arrangements appropriate? Do they appropriately trade off the systemic risk reduction and the incentive benefits with the liquidity, operational and transition costs associated with implementing the requirements? Are the proposed triggers and dates that provide for the phase-in of the requirements appropriately calibrated so that (i) the largest and most systemically-risky covered entities would be subject to the margining requirements at an earlier stage so as to reduce the systemic risk of non-centrally cleared derivatives and create incentive for central clearing, and (ii) the smaller and less systemically risky covered entities would be allowed more time to implement the new requirements? Should the phase-in arrangements apply to the exchange of variation margin, in addition to the exchange of initial margin as currently suggested? Or, given that variation margin is already a widely-adopted market practice, should variation margin be required as soon as the margin framework becomes effective (on 1 January 2015 as currently proposed) so as to remove existing gaps and reduce systemic risk? Do differences of market circumstances such as readiness of market participants and relatively small volumes of derivatives trading in emerging markets require flexibility with phase-in treatment, even for variation margin?

The proposed thresholds applied to the entire notional of non-cleared derivatives entered into by any covered entity and the phase-in arrangement reflect our view that initial margin should only apply to the entities that contribute to systemic risks. These are typically the parties with the bigger trading positions over and above the proposed thresholds. Again, we argue that pension funds should be exempt from initial margin by their nature of using derivatives for hedging purposes and credit quality.

However, we argue that the exchange of variation margin should be implemented earlier, preferably at one moment in time for all entities to reduce systemic risk as soon as possible. There is no reason to grant exemptions on the basis of the products traded. Any product that can give rise to credit exposure should be subject to variation margining.

It remains unclear under the current phase-in arrangements what will happen after 2019. If there is only one covered entity for which the entire notional of non-cleared derivatives exceeds the threshold applicable at that time, does this entity has to post initial margin unilaterally?

Q4. The BCBS and IOSCO seek comment on the accuracy and application of the QIS results discussed above.

We have nothing to add to the QIS findings. These gross figures should typically come from the banking industry.