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Response to the Joint Discussion Paper on Draft Regulatory Technical Standards

Introduction to Cardano

Cardano provides innovative risk management solutions to institutional clients to help them achieve their strategic financial objectives. Our clients are both financial and non-financial institutions and predominately European Pension Funds and Insurance companies. We execute OTC derivatives on behalf of our 40 institutional clients who range in size from ü 300 million to ü15 billion in assets under management. Our clients use our services to mitigate the interest rate and inflation risks inherent in their liability structure, as well as to manage the risk of their equity portfolios, to manage their solvency level effectively. Annually, we execute for our clients approximately ü50 billion in interest rate and inflation derivatives, ü10 billion in equity derivatives and ü20 billion in FX derivatives.

Cardano's Position

Cardano is focused on ensuring that the EC proposals for OTC derivatives are aligned with supporting an environment for effective risk management for OTC derivative end users. We acknowledge the general objectives of the new legislation and the desire for reporting and increased transparency, but are concerned about certain aspects of the implementation of the EMIR legislation. Amongst others:

- IORPs and Insurance companies depend heavily on OTC derivatives markets for hedging the financial risks inherent in their balance sheet. The high amount of additional costs and operational burden imposed upon them may negatively incentivise such entities to stop using derivatives as a risk management tool and accept more market risk in their balance sheets
- Eligible collateral for margining, should remain definable as per the existing ISDA CSA documentation framework, including definitions such as Minimum Transfer Amounts (MTA)
- Financial losses at default arising from replacement risk can substantially outweigh the losses related to not having IM, hence it is not such that IM reduces all residuals risks at default
- More consideration should be given to high costs of clearing for financial end users of OTC Derivatives and clearing exemptions and thresholds should also apply for IORPs and insurance companies that use OTC derivatives solely for hedging financial risks
- More effort is needed on providing positive incentives to promote market liquidity in non-cleared OTC derivatives. Short term negative incentives such as higher capital charges and IM on uncleared derivatives will have the unintended consequence that less classes of OTC derivatives become eligible for clearing in the longer term

We are very concerned that insufficient time is available to perform impact assessments from the perspective of different market participants and on the downstream consequences on other markets. Too much focus on achieving the implementation timelines will negatively impact the quality of the technical standards and increase the probability of unintended consequences. Currently there are only a few entities offering clearing services to a select number of clients. Given the current time squeeze, the usual forces of free markets are unlikely to work. The proposed legislation will introduce systemic liquidity risk, which banks will pass on to their clients even though the banks are to blame. We urge EMSA to consider a long term phased implementation approach focusing namely on system banks.

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Introduction

We would like to begin by stating that we are very concerned that the benefits of bi-lateral collateral management are not well understood, specifically with regards to the diversification of counterparty risk and the mitigation of replacement risk. It is common that end users maintain multiple bi-lateral ISDA/CSA relationships to support the risk management of their OTC Derivatives portfolio. Diversification is a proven cost effective means of mitigating both counterparty and replacement risk at default. Multiple clearing members for small users of OTC derivatives are very expensive to maintain. Central clearing promotes a concentration of counterparty risk to the clearing member and this also results in a higher amount of replacement risk if the specific clearing member (CM) defaults. From a holistic risk management perspective, the concentration of risk inherent in the CCP model can only be mitigated by having a sound legal and operational framework for portability during default. Without a solid framework for portability, we do not feel that it is prudent from a risk management perspective to promote clearing as being more risk effective than bi-lateral collateral management.

Hereby a simplified comparison between the bi-lateral collateralised ISDA/CSA relationships and central clearing member relationship from a holistic risk management perspective:

Table: Diversified portfolio of ISDA/CSA relationships versus concentrated CCP portfolio

In EUR millions	Bank 1	Bank 2	Bank 3	Bank 4	Bank 5	CM
# transactions	6	6	6	6	6	30
Notional	100	100	100	100	100	500
MTM	10	10	10	10	10	50
VM Collateral	10	9	11	9	11	50

The above table illustrates a € 500 million end-user portfolio managed in a well-diversified ISDA/CSA portfolio of derivative exposures versus it managed with a single CCP clearing member. The positive portfolio MTM represents a directional portfolio typical of buy-side financial institutions that use derivatives to hedge the commercial financial risks inherent in their balance sheets.

Let's assume in the above example of a diversified portfolio of ISDA/CSA relationships that Bank 4 goes into default. The end-user will have a loss of €1 million due to having insufficient VM to cover the open derivatives exposure at default. The 6 derivative transactions with Bank 4 totalling €100 million in notional are terminated and will need to be replaced to ensure that the required financial hedge is maintained. This €100 million notional in derivatives will need to be executed in what is expected to be volatile and illiquid market conditions. Let's further assume that the portfolio consists only of 30 year interest rate swaps and 30 year swap rates fall 20 bps before the hedge positions could be replaced. This would result in an additional loss of approximately €4 million due to the market risk inherent in the now unhedged financial position. We would like to emphasise that IM only covers shortfalls in collateral up to the market value determined at default. Replacement risk is a default risk that cannot be mitigated by having IM requirements for bi-lateral trades.

We now assume that the above €500 million portfolio was held with a single CM whom went into default and that the entire end-user portfolio was liquidated as part of the CCP default management process as portability was not supported by the CCP. We assume that there was sufficient VM collateral to cover the market value of the derivatives at liquidation. From a pure counterparty risk perspective there is no loss at default however from a holistic risk management perspective, the end client has substantially more market risk at default now than in the above situation. The end-user is now in the precarious position that they no derivatives outstanding to hedge the market risk inherent in its balance sheet and must replace the entire €500 million in derivative notional in what is expected to be volatile and illiquid market conditions. Here again we assume the portfolio consists of 30 year OTC derivatives and 30 year swap rates fall 20 bps before the €500 million in derivative hedges could be replaced. This would result in a financial loss of approximately € 20 million resulting from the market risk inherent in the now unhedged financial position of the end user that IM does not address.

From a holistic risk management position, end users of derivatives who use derivatives predominately for risk management purposes have no benefit of their OTC derivatives being liquidated at default. Replacement risk is largest for those entities using derivatives for hedging purposes that tend to have large one way directional OTC derivatives portfolios. The concentration of replacement risk inherent in the central clearing model combined with the portability not being enforced through legislation, results in higher market risk at default than with a diversified bi-lateral ISDA/CSA portfolio. Managing counterparty risk at default cannot be seen in isolation from managing market risk at default arising from replacement risk. Under centralized clearing, the only means to manage replacement risk is to ensure sufficient technical standards for the legal and operational mechanism needed to support portability. We therefore advocate that when defining the technical standards, ESMA takes a more holistic approach understanding all the risks at default to all market participants using OTC derivatives and not make decisions that overly benefit one group of participants at the cost of another. Legislation must sufficiently mitigate the too-big-to-fail position that CMs will become and make mandatory portability the responsibility of CCPs before having östickö measures in the current bi-lateral model to incentivise CCPs.

We recommend that IM for bi-lateral trades only become introduced once CCPs, with all unknown systemic implications on scarcity of collateral, are mature and deemed effective from a holistic risk management perspective. For all the above reasons, we are not supportive of the viewpoint of EMIR that central clearing is equally beneficial for all market participants and that clearing should be incentivised regardless of costs. More attention should be given on how to promote clearing from a öcarrotö perspective that creates liquidity in less mature OTC derivatives products without creating disincentives to sound risk management. Without cultivating an environment for enabling more products to qualify for central clearing, no amount of östickö measures such as having IM on bilateral trades will be effective in incentivising clearing. We are not convinced that IM for bi-lateral trades reduces systemic risk nor that all the direct and indirect costs of IM are well known.

Below we have provided feedback to the specified questions.

Summary of proposals

Q1. What effect would the proposals outlined in this discussion paper have on the risk management of insurers and institutions for occupational retirement provision (IORPs)?

In our view not all of the Regulatory Technical Standards (RTS) proposed in the Joint Discussion Paper are expected to materially improve the risk management OTC derivatives for IORPs and insurers while they are expected to lead to significant increases in costs. We therefore question if the expected benefits of the proposals outweigh the expected and unexpected costs. Cardano estimates that of the current notional and type of OTC derivatives contracts outstanding with its clients, 60% would be clearing eligible and 40% would remain on a bi-lateral basis due to insufficient liquidity. We feel that it is very unlikely that 100% of the OTC derivatives used by IORPs and insurers will ever become clearing eligible and duplicate infrastructure will be required to support both central clearing and IM.

We are very concerned that due to cost increases and IM requirements some types OTC derivatives will become so illiquid that they will no longer be traded despite being today an effective risk management tool. In addition, in some cases the costs of implementing solid risk management tools might be perceived as higher than the (potential) cost of not having risk management in place at all. Systemic risk may take another form wherein IORPs and insurers retain too much financial risk and in adverse market conditions, cannot meet the obligations of its stakeholders. For further motivation of this view, see our answers to the other questions.

IV.2 Options for initial margins. Option 1: The posting of IM by all counterparties

Q2. What are your views regarding option 1 (general initial margin requirement)?

Q3. Could PRFCs adequately protect against default without collecting initial margins?

Q4. What are the cost implications of a requirement for PRFC, NPRFC and NFCs+ to post and collect appropriate initial margin? If possible, please provide estimates of opportunity costs of collateral and other incremental compliance cost that may arise from the requirement.

Cardano is not in favour of IM requirements. IM remains operationally complex and risky from a credit and legal risk perspective. In addition the downstream consequences of a squeeze in eligible collateral are unknown from a systemic risk perspective. We consider the cost and risks related to IM requirements and their daily impact on all organisations, to outweigh its limited contribution in reducing systemic risk.

IM is by definition over-collateralisation of a current OTC derivatives exposure and all forms of over-collateralisation represent credit risk and possible legal risk. Cardano oversees more than 175 CSA relationships and currently there are no instances where IM is exchanged. Without segregation, IM posted two-ways is offsetting and the protection is nullified. While VM is based on a real and current exposure, IM is based on a future potential exposure ignoring estimations of loss given default based on the credit quality of entities. In the consultation paper it is not explicitly stated that IM needs to be held under all circumstances with an independent 3rd party however any other form of IM exchange could increase counterparty credit risk, especially if this exchange is in a title transfer basis that allows for re-hypothecation.

Although most of our clients hold received variation margin (VM) collateral on a segregated basis we are aware that the banks hold the VM collateral posted to them on a non-segregated basis and re-hypothecate the collateral. Cardano supports re-hypothecation of VM as legally the client has the right of set-off against the market value of the relevant portfolio of derivatives. Any IM requirements

should take into consideration how best to mitigate legal and credit risk. In our opinion this is best mitigated by ensuring 3rd party intervention in the segregation of IM and preferably the legal basis should not be title transfer but pledge or other form of event dependent transfer.

In general we feel that the expected amount of collateral required to support IM for the current amount of outstanding OTC derivatives outstanding is extremely large and not well understood in the industry. The maturity profile of standard OTC derivative contract is substantially longer than that of a standard future contract, specifically it is normal to have interest rate swaps maturing in a period of 30-50 years while not many future contracts have a maturity longer than 3 months. This means that for the same amount of contract notional, the IM of the future could be 6-8% of notional while that of a 50 year swap can be 22% of notional. We strongly urge ESMA to perform and publish an impact assessment with the derivative portfolios of the top 25 OTC derivative banks in Europe to make estimated of the gross amount of IM (i.e. that both the bank and the end user would need to post) based on their current CSA relationships and compare this with the estimates of available collateral. An assessment would then need to be performed on what the impact would be on collateral markets for applying IM for both cleared and non-cleared transactions. A scenario analysis could be performed to estimate what the impact of a squeeze in available eligible collateral would have on repo, financing and collateral markets. Without such analysis it remains unclear if IM actually reduces credit and systemic risks.

Not all end users of derivatives have sufficient eligible financial assets available for posting for IM while they have sufficient other assets such as real-estate, inventories, etc. For example Pension Funds have diversified investments across investment managers while risk management is usually performed centrally. Pension Fund have no or very little leverage and typically require only 5-7% of its assets to be liquid to meet short term pension obligations. It remains an operational challenge to remove financial assets held with their asset managers custodians to post into collateral arrangements and currently this can result in a high amount of substitutions in the collateral process which increase operational effort and risk. Requiring IM contributes to the cost and complexity and ensuring sufficient collateral is available on a contingent or short term basis. To the extent this results in cash financing or holding cash assets then the costs of managing collateral requirements can substantially negatively impact the business model of the end user, regardless of classification of Non-Financial Counterparties (NFC) or Financial Counterparty (FC). See cost details in response to Q4.

We feel that PRFCs could adequately protect themselves against default by improving their internal risk management capabilities and reducing the amount of leverage in their balance sheets. Default is a holistic risk management issue and cannot be isolated to one aspect of the balance sheet of a PRFC. In the cases of AIG and Lehman Brothers we feel it is a classic example of having too many eggs in one basket and not being able to monitor the eggs. These institutions are likely to have lacked the internal risk management framework that not only monitors current risks but also performs scenario analysis to identify potential risks. We feel that IM only addresses one aspect of risk on the balance sheet of systemically risky institutions and may even lead to a false sense of security that may prevent the required improvements in internal risk management. We are not convinced that the fact that they are prudentially regulated is a distinctive factor for adequate protection against default and nor are we convinced that IM is the appropriate means of preventing future defaults.

The following costs are related to having daily management of IM, and are highly dependent on amount of CSA relationships, transactions and market risk.

Infrastructure related:

1. Additional operation staff to calculate and instruct IM collateral movements on a daily basis and monitor timely settlements next day and interact with banks and 3rd party custodian on IM issues. All these processes require sufficient division of duties and controls. Most FCs are dependent on the internal capabilities and payment processing timelines of their custodians and 3rd party service providers.
2. Additional Treasury/Investment Management/Risk staff to ensure sufficient collateral is available for IM, monitor credit risk and control IM calculations and models

3. Additional accounting staff to monitor daily bookkeeping of collateral movements and ensure appropriate accounting reconciliations and controls
4. Legal staff/expense in amending legal agreements with counterparties and establishing 3rd party legal arrangements if required
5. IT staff and investment to ensure that all of the above processes are performed in a controlled an efficient manner
6. Tri-Party or other custodian charges related to segregation/pledging of IM
7. Senior Management to oversee above staff and IM related processes

Financing related:

The IM requirements are substantial and are biased against pension funds, insurers, mortgage financing institutions who use derivatives for hedging purposes and whose offsetting financial exposure lies outside OTC derivatives environment. Institutions with sound financial risk management practice tend to be more financially stable than those whom do not practice financial risk management. IM calculations ignore the credit worthiness of an institution and size does not reflect the achieved reduction of financial and therefore systemic risk achieved from using OTC derivatives as hedging instruments.

Assume that a typical medium size pension fund with a total balance sheet of €1.5 billion has an €1 billion portfolio of long dated interest rate and inflation derivatives. Assuming an average IM requirement of 12% of notional this would result in the requirement to post €120 million in IM. From a credit risk perspective we feel that it is never, under any circumstances whatsoever, prudent to post IM with bank counterparties on an unsecured basis. In the above example this would mean that 8% of a Pension Funds assets would be posted in IM which is a substantial amount of credit risk that currently is not incurred. From a regulatory perspective the EIOPA needs to provide clear guidance on how to prudently manage IM from a credit risks perspective.

If IM requirements can be met using available marketable financial assets then for Pension Funds the impact is limited to when it holds insufficient collateral to meet both VM and IM collateral requirements. This is not always the case for Pension Funds and it should also be noted that many FCs do not own marketable financial assets but ineligible collateral assets such as mortgages, car leases, guarantees. In these circumstance we assume that the IM requirement would need to be funded in cash and the costs thereof are estimated in the current example as follows:

1) Borrow €120 million from Bank A at	EONIA + 3.00%*
2) Invest IM in money market funds at	EONIA + 0.00%
3) Negative cost of carry assuming cost borrowing	-3.00%
4) Annual cost on €120 million IM	€3,600,000

*Banks lending rates are a spread over their borrowing costs and usually defined against LIBOR, Bank CDS spreads are good estimates

The negative cost of carry is highly volatile and dependent on market (re)financing conditions. It is also entity specific depending on the credit quality of the institutions and the bank relationships. The above assumes that the statutes of a Pension Funds or other entity enable the borrowing of funds to meet collateral requirements. Otherwise other forms of balance sheet management will be required to manage the contingent nature of collateral requirements. It should be noted that in this case IM has not effectively reduced credit risk but has only changed the form of the credit risk from a future risk (credit risk at default) to a current risk (a loan). It is also not efficient to borrow from one bank to post as collateral to another. This is also not capital efficient for the banks. We feel that capital charges are a more effective means of managing systemic risk than IM.

Costs related to IM can be seen as insurance premium that covers the loss of default. Assuming that financial charges are €3,600,000 as per above and infrastructure charges are very approximately estimated at €600,000 then managing an annual IM of €120 million would result in an annual charge of €4.2 million. This amounts to an annual reduction of 0.28% return on assets or an immediate

reduction of 5.6% of the solvency ratio assuming a 20 year duration. Our concern is that pensioners are paying to reduce systemic risk of banks and not bank shareholders or bank staff. Pension Funds and insurer will have lower returns as a result of the additional costs of managing IM requirements but given the expected shortage of eligible collateral, the traditional assets that Pension Funds and Insurers invest in will, due to scarcity, have low returns which again, negatively impacts pensioners and other long term consumer savings more than other users of OTC derivatives.

IV.2 Options for initial margins. Option 2: The collection of IM by PRFCs only

Q5. What are your views regarding option 2?

Q6. How – in your opinion - would the proposal of limiting the requirement to post initial margin to NPRFCs and NFCs+, impact the market / competition?

We are not at all in favour of option 2. In option 2 it is our view PRFCs are advantaged over NPRFCs and NFCs. From a credit risk perspective we feel that it is never, under any circumstances whatsoever, prudent to post a material % of assets with bank counterparties on an unsecured basis. Especially for certain PRFCs this seems like an inappropriate reward for their past risk management track record. Please also see responses to above questions.

In our view such proposal is likely to lead to unfair competition and differences in pricing. We feel that the same rules should apply for all parties to maximize market transparency and liquidity. We also feel that this may stifle innovation in financial markets. The benefits of IM in terms of reduction are system risk must be clearly demonstrated to justify the costs. It remains unclear what the contribution is of IM in reducing systemic risk and specifically what the systemic risk benefit would be is only a subset of market participants would be subject to the requirement. We are strongly against putting the interests of bank shareholders above those of pensioners and other long term savers.

IV.2 Options for initial margins. Option 3: PRFCs would not be required to collect IM if the exposure is to certain counterparties and below a certain threshold

Q7. What is the current practice in this respect, e.g.

- If a threshold is currently in place, for which contracts and counterparties, is it used?
- Which criteria are currently the bases for the calculation of the threshold?

Q8. For which types of counterparties should a threshold be applicable?

Q9. How should the threshold be calculated? Should it be capped at a fixed amount and/ or should it be linked to certain criteria the counterparty should meet?

Q10. How – in your opinion - would a threshold change transactions and business models?

None of our clients are required to post IM under their ISDA/CSA collateral arrangements and therefore in that context thresholds currently do not exist. It certainly is NOT market practise for pension funds and insurance companies to post IM. Having IM will change business models substantially as new infrastructure would need to be established across all clients to manage IM which if required to be on a daily basis, may double operational processing of collateral movements. We suggest to have high thresholds applicable to those high quality end-users that can demonstrate that they use derivatives for hedging purposes. We would prefer to recalculate IM on a less frequent basis than VM, and related to underlying transactions in the portfolio. Higher thresholds and higher minimum transfer amounts (MTAs) should be applied to IM to minimize the operational burden.

IV.2 Options for initial margins. On all options:

Q11. Are there any further options that the ESAs should consider?

Q12. Are there any particular areas where regulatory arbitrage is of concern?

Q13. What impacts on markets, transactions and business models do you expect from the proposals?

We expect that all entities subject to these regulations will try to optimize the costs / benefits on their business models. An entity could for example move certain investments and infrastructure to different jurisdictions with less stringent regulations and this will negatively impact both access to knowledge and jobs within a jurisdiction.

The proposals may result in less use of derivatives for prudent risk management and therefore a higher risk acceptance by parties that now are able to mitigate their financial risks. Affected parties may look to use less transparent structured products as alternative means to manage financial risks.

We expect more dependency on repo markets and short term financing markets which in itself can represent new forms of systemic risk.

IV.3 Variation margin

Q14. As the valuation of the outstanding contracts is required on a daily basis, should there also be the requirement of a daily exchange of collateral? If not, in which situations should a daily exchange of collateral not be required?

Q15. What would be the cost implications of a daily exchange of collateral?

While valuation may be required on a daily basis, we are not supportive of having mandatory daily exchange of collateral for all entities. Monthly, bi-weekly or weekly are common frequencies in existing ISDA/CSAs for entities which have a limited amount of OTC derivatives outstanding and limited operational infrastructure. The benefits of a more frequent exchange of collateral does not necessarily result in a better risk-return position for an entity but it is important that a cost benefit analysis is performed.

We feel that for small movements in valuations collateral should not be exchanged. The costs and operational effort outweigh the benefit. Having higher MTA of e.g. EUR 1,000,000 is a risk based approach to have less frequent exchange of collateral than but still ensuring that when large market movements occur that sufficient collateral is exchanged. MTAs are standard market practice and having a higher MTA minimizes the operational effort while having negligible impact in terms of increasing systemic risk.

The cost implications for an entity that currently has no daily collateral management is similar to the costs identified in Q4 in terms of infrastructure and financing. Depending on the number of CSAs, our experience is that the daily exchange of collateral can be outsourced for approximately EUR 150,000 to EUR 300,000. That being said while the processing can be outsourced the management oversight, collateral availability and certain re-financing requirements cannot be outsourced thus these costs are additional.

Assuming European bonds remain eligible as collateral for VM then the financing related costs are limited for Pension Funds. For Insurers and other FCs whom have less eligible financial assets to exchange, cash financing would be required and a financial loss would be incurred between the cost of borrowing and the return stipulated for cash collateral in the ISDA/CSA. See cost of carry example in response to Q4.

IV.4 Initial margin: Initial Margin Calculation (1)

Q16. Do you think that the “Mark-to-market method” and/or the “Standardised Method” as set out in the CRR are reasonable standardised approaches for the calculation of initial margin requirements?

Q17. Are there in your view additional alternatives to specify the manner in which OTC derivatives counterparty may calculate initial margin requirements?

Q18. What are the current practices with respect to the periodic or event-triggered recalculation of the initial margin?

Q19. Should the scope of entities that may be allowed to use an internal model be limited to PRFCs?

Q20. Do you think that the “Internal Model Method” as set out in the CRR is a reasonable internal approach for the calculation of initial margin requirements?

Q21. Do you think that internal models as foreseen under Solvency II could be applied, after adequate adjustment to be defined to the internal model framework, to calculate initial margin? What are the practical difficulties? What are the adjustments of the Solvency II internal models that you see as necessary?

Q22. What are the incremental compliance costs (one-off/on-going) of setting up appropriate internal models?

Q23. To what extent would the „mark-to-market method“ or the „standardised method“ change market practices?

We advocate a simplified approach in calculating the IM. The advantage of a simplified approach is that there is less movement in collateral due to market changes. Having a more stable IM calculations would result in less operational handling and less operational risks. In addition it would ease operational burden of calculating and controlling IM calculations. It is highly inefficient that a buy-side user of derivatives with 12 ISDA/CSA relationships would need to control 12 different IM calculations based on 12 different bank models and that on a daily basis!

We are concerned about the pro-cyclicality of IM models and the impact that has on being able to manage collateral requirements. If the amount of the IM depends on market parameters, adverse market movements will lead to increased IM to be posted possibly further impacting the markets. For counterparties to the same transaction, we do not feel that the amount of IM should be calculated on different models. Allowing for internal models to be used for calculating the IM will lead to arbitrage opportunities between counterparties or distort market competition.

We have no clients who exchange IM and thus are unaware of current practices with respect to periodic or event-triggered recalculation of IM.

We are aware of the fact that IM in the current ISDA/CSA process is a fixed amount, irrespective of number of trades outstanding. There is no MTM or revaluation that we are aware of. All models by definition will result in new market practice and thus new operational processes and infrastructure for many market participants.

IV. Initial margin: Initial Margin Calculation (2)

Q24. Do you see practical problems if there are discrepancies in the calculation of the IM amounts? If so, please explain.

Q25. Would it be a feasible option allowing the party authorised to use an internal model to calculate the IM for both counterparties?

Q26. Do you see other options for treating such differences?

There will always be discrepancy if one cannot agree to the model being used. If different models are used then it is difficult to determine whose calculation is appropriate. Therefore it becomes difficult to have a clear dispute resolution mechanism.

This creates inconsistencies between parties and could lead to counterparties working on internal models that result in the least amount of IM to attract the highest amount of derivative business. See above response on Initial Margin Calculation (1).

IV.4 Initial margin: Segregation and Re-use

Q27. What kinds of segregation (e.g., in a segregated account, at an independent third party custodian, etc.) should be possible? What are, in your perspective, the advantages and disadvantages of such segregation?

Q28. If segregation was required what could, in your view, be a possible/adequate treatment of cash collateral?

Q29. What are the practical problems with Tri-Party transactions?

Q30. What are current practices regarding the re-use of received collateral?

Q31. What will be the impact if re-use of collateral was no longer possible?

From a credit risk perspective we feel that it is never prudent to post a material % of assets with a bank counterparties on an unsecured basis. Especially for some banks this seems like an inappropriate reward for their past risk management track record. The advantage of segregation is that residual potential credit risk at default is mitigated. The disadvantages are that the cost of this infrastructure is a real, annual cost while the exposure it mitigates is a potential future loss. We consider IM and the cost of managing it a form of insurance, albeit we feel that this potential loss can more cost effectively be mitigated by having a diversified portfolio of counterparties and a robust counterparty credit review process.

If IMs are required, they must be fully segregated. In a legally remote entity from the relevant counterparty.

Cash collateral could be reinvestment in money market funds assuming it is held at a (3rd Party) custodian. To minimise the amount of daily cash transfers both to the segregated account as well as to the money manager, it is operationally efficient not to have daily movements in IM but a more stable IM calculation.

Tri-Party transactions are not as commonplace as use of OTC derivatives. A large proportion of OTC derivative end users and their legal advisors will need to be educated in Tri-Party. Legally as well as operationally, a significant amount of time is required for the industry of custodians and other entities to on-board and operationalize new Tri-Party relationships.

Cash VM must be reinvested in order to generate income to compensate for the interest payable under VM. Our clients hold bond collateral received for VM on segregated accounts. The impact of not being able to reuse collateral is a scarcity of high quality collateral. Thus the benefits of IM should be very carefully weighted off against both the direct as well as indirect costs.

IV.5 Eligible collateral

Q32. What are, in your view, the advantages and disadvantages of the two options?

Q33. Should there be a broader range of eligible collateral, including also other assets (including non-financial assets)? If so which kind of assets should be included? Should a broader range of collateral be restricted to certain types of counterparties?

Q34. What consequences would changing the range of eligible collateral have for market practices?

Q35. What other criteria and factors could be used to determine eligible collateral?

The range of eligible collateral for IM should be broader than that of VM. We feel that pledges and guarantees should also be considered eligible.

IV.6 Collateral valuation / Haircuts

Q36. What is the current practice regarding the frequency of collateral valuation?

Q37. For which types of transactions / counterparties should a daily collateral valuation not be mandatory?

Q38. What are the cost implications of a more frequent valuation of collateral?

Monthly, bi-weekly, weekly and daily are all types of frequency of collateral exchange that the market supports wherein both the collateral and the derivatives portfolio are re-valued. The frequency is agreed between the two parties depending on both the level of operational infrastructure available and the amount of risk each party is willing to bear. Daily exchange of collateral is performed for the majority of our clients.

Collateral is valued in accordance with the timing frequency stipulated under an ISDA/CSA. If collateral frequency is daily then it is valued on a daily basis, next day as this is usually dependent on overnight system batch processing.

No distinction is made between transactions or counterparties.

IV.7 Transactions with counterparties outside the EU

We have no comments.

IV.6 Collateral valuation / Haircuts

Q39. Do you think that counterparties should be allowed to use own estimates of haircuts, subject to the fulfilment of certain minimum requirements?

Q40. Do you support the use of own estimates of haircuts to be limited to PRFCs?

We support that haircuts for traditional forms of collateral are centrally decided upon in order to make the bi-lateral ISDA/CSA more standardised between market participants. For non-traditional forms of collateral, we support that PRFCs can negotiate haircuts based on their own estimates.

IV.8 Risk management procedures, operational process for the exchange of collateral and minimum transfer amount

Q41. In your view, what criteria and factors should be met to ensure counterparties have a robust operational process for the exchange of collateral?

Q42. What incremental costs do you expect from setting up and maintaining robust operational processes?

Q43. What are your views regarding setting a cap for the minimum threshold amount? How should such cap be set?

Q44. How would setting a cap impact markets, transactions and business models?

We have no comments.

IV.9 Intra-group exemptions

Q45. In your views, what should be considered as a practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between the counterparties?

Q46. What is the current practice regarding the collateralisation of intragroup derivative transactions?

We have no comments.

IV.10 Cost-benefit analysis

Q47. What is the impact of the presented options on the capital and collateral requirements of the counterparties affected by the relevant provisions and the span of time necessary to comply with the Regulation?

Organisations have scarce resources to apply to large scale change initiatives. The issue from a time span perspective is that there is too much regulation changing at the same time aimed at pension funds and insurance companies (apart from EMIR also MiFiD II, Solvency II, IORP directive ñ in part interfering with EMIR regulation), and the impact of the regulation is insufficiently understood. Our preference would first to ensure that the clearing obligations are met for the most systemically risky entities and for the widest possible range of OTC derivatives and only then broaden the regulatory obligation to other entities, depending on perceived riskiness/leverage. Once the impact on OTC derivative markets and underlying collateral markets are known then we believe it is prudent to widen the scope to other entities and to bi-lateral markets. Many institutions will always have a mix of cleared and uncleared derivative contracts. We feel it is not prudent to expect entities to operationally embed central clearing in an organisation and at the same time embed the operational requirements of Tri-Party IM and MiFiD. We recommend a long implementation period to give organisations the ability to sufficiently embed new processes in a controlled manner in their organisations.