Capital Markets Unit
Corporations and Capital Markets Division
The Treasury
Langton Crescent
PARKES ACT 2600

10th April 2014

Dear Mr. Lim,

Treasury proposals paper: G4-IRD central clearing mandate - submission

1. Do you have comments on the benefits and costs of complying with a mandatory central clearing obligation, from the point of view of your business and/or that of your customers?

We request that, in commenting, you quantify compliance costs as far as possible, including whether costs are likely to change over time, are transitional or projected ongoing costs. For example, costs may include:

- *legal costs;*
- *staff cost — for example number of staff hours and training costs;*
- *IT costs; and/or*
- *increased costs of managing risks or funding projects*

Please separate additional costs that would come about as a result of this proposal, as well as other regulatory costs that could be mitigated if you are able to comply with Australian regulation rather than many different countries' regulations.

To assist this analysis it would be useful to know whether your trades, and/or those of your clients, are becoming subject to central clearing obligation from other countries and whether your counterparties prefer central clearing of trades.

Response to question 1: GreySpark feels that this question would be better answered by Australia's dealer banks and would therefore prefer not to opine on their trade volumes/costs.

2. Do you have comments on the proposal to mandate central clearing in respect to G4 IRD? Please also consider the costs and benefits of a wider or narrower scope. Could you comment on the incremental costs and benefits of a broader or narrower scope of coverage? For example, including only USD IRDs or alternately including all IRDs.

Response to question 2: GreySpark Partners thanks the Australian Treasury for the opportunity to comment on its G4-IRD central clearing mandate proposals paper.

GreySpark Partners is a global capital markets consultancy firm, with offices in London, Hong Kong and Sydney. GreySpark provides expertise in risk, e-trading and market structure and offers business, management and technology consulting services. In Australia, GreySpark offers the aforementioned services alongside additional services within the market structure remit in

OTC reforms, to assist clients in preparing for the impacts of regulatory change. In this deeply client focussed role, GreySpark feels it has both a duty and an obligation to respond to the Treasury's request for comments and feedback.

GreySpark welcomes the proposed G4-IRD clearing mandate and views this as a positive development in ensuring Australia is consistent with the changes taking place in the U.S. and the EU. The incremental cost for the dealer community in implementing changes to prepare for clearing will be minimal, due to the fact that the local banks who are already registered as swap dealers with the CFTC are already clearing OTC derivatives trades frequently.

There is benefit in opening up the dealer-to-dealer clearing mandate to AUD-IRD at the same time as the G4-IRD mandate as well - the key benefit being international consistency. The AUD-IRD mandate would not require significantly more spend from the large dealer banks as they currently clear AUD-IRD with international counterparties. Therefore, the incremental effort and cost for dealers to comply with an AUD-IRD mandate is anticipated to be minimal.

In the interest of international consistency and ensuring that Australia is not seen to be falling behind in its G20 commitments, it is important that there is a proposed timeframe for client clearing to be mandated in Australia. The costs relating to the buildout and maintenance of an OTC derivatives client clearing offering will, however, be significant for banks who are not already offering a clearing broker offering, as well as hedge funds and buyside firms who will be the key clients in the client clearing model. The technological costs are predominantly around building out new connections to clearinghouses, SEFs, affirmation platforms and trade repositories. There is also the ongoing cost of staffing teams to support the clearing and collateral workflows as well as ongoing projects, process improvements and related testing ongoing enhancements. Investment in enterprise clearing systems such as Murex and Calypso would also require significant funding, buildout and testing.

To adhere to international norms and standards, it would also be in the interest of the Australian OTC derivatives markets for Credit derivatives and Non-Deliverable Forwards to be cleared in the future. A timeline would need to be proposed by regulators to address this and it is in the interest of the wider market that dates are proposed sooner rather than later and clear proposal made publicly available, to avoid confusion and uncertainty amongst the smaller buyside firms.

3. Do you agree with the proposal to restrict ASIC rulemaking to entities that are considered to be G4 Dealers, and to exempt intra group trades? Could you comment on the incremental costs and benefits of including or exempting other types of entities or transactions? For example including all AFSL holders and ADIs or alternately setting a high threshold of activity.

Response to question 3: We feel that the approach by the regulators in Australia has so far been measured and cautious. The phased approach taken by ASIC to mandating reporting to trade repositories has certainly been viewed by Australian market participants as reasonable and practical, as opposed to the "big bang" method applied by the European regulators in implementing the European Market Infrastructure Regulation ("EMIR"), which mandated trade reporting on a singular start date for all market participants.

While the Australian regulators have indicated that they are keen for the market to naturally move to clearing prior to setting a mandate for central clearing of OTC derivatives, it has been GreySpark's firsthand experience that the buyside is largely delaying their commitment to and

preparation for clearing until a mandate is announced by regulators. The Treasury proposals paper on mandatory clearing for the Interest Rates Derivatives denominated in the G4 currencies ("G4-IRD") also does not provide a clear indication of when buyside firms will be expected to comply with mandatory clearing and does not also propose a clear timescale for clearing of Interest Rates Derivatives denominated in AUD ("AUD-IRD"). The lack of clear direction for the buyside raises the risk that when liquidity for OTC derivatives inevitably shifts from bilateral to cleared markets, firms who are unprepared for this change may lose access to liquidity if they have not already secured access to clearing via a clearing broker - this scenario is plausible due to the fact that the clearing brokers who are currently operating in the Australian market cannot guarantee that they will on-board every client who wishes to clear with them and will certainly pick and choose which clients they will take on. Therefore, GreySpark's view is that it would be prudent on the part of Treasury and the Australian regulators to provide buyside firms with an indicative timeline of when an OTC derivatives clearing mandate is expected to impact them, in order to ensure that the market is best prepared in a timely manner for this change.

In terms of the global OTC derivatives clearing landscape, mandatory clearing is already live in the U.S. and is widely expected to commence in EU in early 2015. From GreySpark's extensive discussions with Australian industry participants, a reasonable deadline for mandatory clearing for the G4 dealers for AUD-IRD would also be in early 2015, aligning with the proposed G4-IRD mandatory clearing commencement date, which impacts the 13 firms identified as G4 dealers in the Treasury proposals paper. There is benefit in opening up the dealer-to-dealer clearing mandate to AUD-IRD at the same time as the G4-IRD mandate as well - the key benefit being international consistency. The AUD-IRD mandate would not require significantly more spend from the large dealer banks as they currently clear AUD-IRD with international counterparties. Therefore, the incremental effort and cost for dealers to comply with an AUD-IRD mandate is anticipated to be minimal.

In order to ensure that Australia does not fall too far behind the global timelines for clearing and not be seen as lagging behind in their G20 commitments, it would be judicious to not leave the buyside clearing mandate until 2016 and instead implement this in late 2015 alongside, or shortly after, the AUD-IRD mandate. In the interest of only mandating systemically important counterparties to clear, it would be prudent for the regulators to impose a clearing threshold for ADIs and AFSL holders, to whom this mandate should be made applicable should their OTC derivative activity exceed a pre-set threshold per asset class. This approach would be in line with the phased rollout method adopted by the U.S. regulator Commodity Futures Trading Commission ("CFTC") in implementing mandatory clearing and would certainly give buyside firms in Australia enough time to prepare. Buyside firms who are currently holding off moving forward with clearing arrangements would also then be able to firmly commit to kicking off their preparations for entering the clearing arena. Providing the buyside with at least a tentative timeline would eliminate much of the uncertainty and confusion that such firms are facing today in relation to future Australian clearing timelines.

4. Do you have comments on the calculation methodology used for determining the proposed threshold of activity and the appropriate level of the threshold? Do you have views on whether notional OTC derivatives or notional OTC IRDs is the more appropriate basis for calculating the threshold? Or would you prefer a different methodology and if so, why?

Response to question 4: In the interests of international consistency, there are benefits for the Australian regime in following the example set under EMIR in implementing a clearing threshold for non-financial counterparties, where such a counterparty is exempted from the

clearing mandate if its positions remain under a pre-defined threshold. The clearing threshold is pre-set in gross notional value and demarcated at individual levels per asset class.

The gross notional methodology of calculating the clearing threshold is a useful one and in our view, would be useful to implement by asset class (for OTC IRDs as opposed to OTC derivatives overall). The reason a split per asset class would be useful is due to the fact that the methodology defined for clearing thresholds would hold good for not only the dealer banks, but also hedge funds and buyside firms who will no doubt be forced to clear via the client clearing model at some stage in the future. Many hedge funds and buyside firms in Australia have a key focus on one or a few asset classes rather than trading across the whole product set and as a result, it would be more practical and in their interest to calculate clearing thresholds per asset class. A gross notional threshold methodology would also be more accurate that a net position methodology, which would result in buyside firms who hold unidirectional positions having to clear more than banks which would hold multidirectional positions in the market.

Similar to EMIR, it would also be useful for OTC trades executed for hedging purposes which are directly linked to commercial activity/funding/treasury to be excluded from the calculation of these clearing thresholds.

Under EMIR, if a non-financial counterparty exceeds a threshold in an asset, then the clearing threshold would be considered as breached for the whole OTC derivatives portfolio and the counterparty would no longer be exempt and would be obligated to clear all swap classes. This approach may not be practical given the size of the Australian market. It would be a more feasible approach to only enforce mandatory clearing for the asset class in which the threshold breach has occurred.

5. Do you have comments on the proposed timetable for implementing the central clearing obligation? Could you comment on the incremental costs and benefits of an earlier or later start date than what is proposed?

Response to question 5: The present timetable for clearing set out by the regulators for the Australian mandate has been far less aggressive than the timeframes set out by the US mandate under the Dodd-Frank Act. Although EMIR in the EU has also been slowly defined by comparison to Dodd-Frank, there seems to be much more clarity under the EMIR proposed mandate for which counterparties will be impacted, and how.

From GreySpark's extensive discussions with Australian industry participants, a reasonable deadline for mandatory clearing for the G4 dealers for AUD-IRD would be in late 2015, following the proposed G4-IRD mandatory clearing commencement in early 2015, which impacts the 13 firms identified as G4 dealers in the Treasury proposals paper. In order to ensure that Australia does not fall too far behind the global timelines for clearing and not be seen as lagging behind in their G20 commitments, it would be judicious to not leave the buyside clearing mandate until 2016 and instead implement this in late 2015 alongside, or shortly after, the AUD-IRD mandate. In the interest of only mandating systemically important counterparties to clear, it would be prudent for the regulators to impose a clearing threshold for ADIs and AFSL holders, to whom this mandate should be made applicable should their OTC derivative activity exceed a pre-set threshold per asset class. This approach would be in line with the phased rollout method adopted by the U.S. regulator, the CFTC, in implementing mandatory clearing and would certainly give buyside firms in Australia enough time to prepare. Buyside firms who are currently holding off

moving forward with clearing arrangements would also then be able to firmly commit to kicking off their preparations for entering the clearing arena. Providing the buyside with at least a tentative timeline would eliminate much of the uncertainty and confusion that such firms are facing today in relation to future Australian clearing timelines.

There are several benefits to onboarding buyside firms onto mandatory clearing sooner rather than later. The key benefit is that it would allow Australian buyside firms to access the increasingly growing pool of cleared liquidity in the U.S. and EU regions. It would also allow them the time to complete full cost/benefit analyses on their clearing models, allow sufficient time for them to do clearing broker selection and enable them to make the best choice of clearing technology, clearing brokers and clearinghouses that are on offer rather than be pushed into a last minute choice after having left their decision to clear too late in the game. In the present state of the market, buyside firms are largely unwilling to commit to clearing. However, once margin requirements are imposed on bilateral uncleared trades, they will find increased incentive to clear – but not many buyside firms seem aware of the fact that this change is coming. Australian buyside firms who are unprepared for this change may lose access to liquidity if they have not already secured access to clearing via a clearing broker - this scenario is plausible due to the fact that the clearing brokers who are currently operating in the Australian market cannot guarantee that they will on-board every client who wishes to clear with them and will certainly pick and choose which clients they will take on. Therefore, GreySpark's view is that it would be prudent on the part of Treasury and the Australian regulators to provide buyside firms with an indicative timeline of when an OTC derivatives clearing mandate is expected to impact them, in order to ensure that the market is best prepared in a timely manner for this change. The lack of clear direction for buyside firms from Australian regulators and the Treasury coupled with a cost-conscious, largely uninformed and nonchalant Australian buyside is creating enormous uncertainty in the market and a clear proposal and timeline on client clearing from the regulators and Treasury would allay some of the uncertainty that is growing in the market.

6. Do you have comments on the proposal that some CCPs may be prescribed in order to ensure Australian market participants have appropriate access to CCPs? Or is there another option you prefer? If so, why?

Response to question 6: It would be useful for CCPs to be prescribed to the Australian market, given that there are only two options locally accessible (LCH and ASX) at the present time. The market could certainly use further direction in terms of the other overseas CCPs that are available, therefore prescribing several options would be of great help.

7. From the point of view of your business and/or that of your customers, what is your preliminary view on the costs and benefits of mandatory central clearing of:

- *AUD IRD?*
- *North American and European referenced CDS?*
- *Any other derivatives?*

Response to question 7: From our deep involvement in the Australian OTC derivatives market, it would have been ideal to have a tentative timeframe specified for AUD-IRD mandatory clearing in the Treasury proposals paper to provide the market with some direction as to when

this would eventuate. Due to the lengthy timeframes required to prepare for clearing readiness and high costs associated with clearing readiness, a tentative deadline would have been very useful in guiding the market in the right direction.

A key benefit of clearing would be the Credit Valuation Adjustment (CVA) charges applied under the Basel III/CRD IV accords. The Basel Committee promotes central clearing through CCPs as per the below:

- Applying a nominal 2% risk weighting for OTC Derivatives cleared through a CCP
- Banks will find it much more expensive to trade bilateral OTC Derivatives due to increased regulatory capital requirements for exposures to non-CCPs

Criteria	**Bilateral & non-cleared**	**Cleared (via Qualifying CCPs)**
Risk weighting of exposure	20% (min), up to 150% (max)	2%[1]
Default fund exposure	N/A	Flat risk weight of 1,250%, capped at 20% of the bank's overall exposures to the CCP
Credit Valuation Adjustment (CVA)	CVA charge applicable	N/A

Therefore the cost of trading bilaterally has increased substantially under Basel III, as Counterparty Credit Risk (under Basel III) = Default Risk of Counterparty (under Basel II) + CVA Risk (newly added under Basel III). This is particularly true for long-dated bilateral swaps, where the CVA charge would be applicable for the life of that trade.

As a specific example, based on an IRS with €100m notional, 3 year maturity, with a BBB rated financial counterparty[2] (funding charge assumed to be 3%):

Therefore, the breakdown of capital charges under Basel II and Basel III would be as follows:

Charges	**Basel II - Bilateral**	**Basel III - Bilateral**	**Basel III - Cleared**
Default Risk Charge	€5,100,000	€5,100,000	-
CVA Charge	-	€7,000,000	-
Trade Exposure - CCP Charge	-	-	€1,000,000
Total Capital Charge	€5,100,000	€12,100,000	€1,000,000
Cost of Funding	€459,000	€1,089,000	€90,000
Total Cost	€5,559,000	€13,189,000	€1,090,000

[1] If prerequisite criteria are met by CCP, CB and buyside client

[2] Fares, Z. and Genest, B., 2013. CVA capital charge under Basel III standardized approach. London: Chappuis Halder & Cie.

Therefore under Basel III, the funding differential between bilateral trading and clearing = €999,000.

In terms of NA and European referenced CDS, due to the low volumes of trading locally, we agree that this is not a priority at present due to the lack of significant levels of activity in the Australian market, but in the interests of international consistency, should be reevaluated over the next 12-18 months.

8. Do you have views on the appropriate timing of the introduction of such mandatory requirements? Are there any preconditions that should be met before such mandatory requirements are introduced?

Response to question 8: The ideal timeframes for a clearing mandate would be in a phased approach, such that each phase is separated by a 6 month interval. A proposed feasible timeline for an IRD mandate is as follows:

- G4-IRD clearing mandate for G4 dealers: Q1 2015
- AUD-IRD clearing mandate for AUD & G4 dealers: Q1 2015
- G4-IRD and AUD-IRD clearing mandate for non-dealer financial counterparties trading over a specified gross notional threshold (per asset class): Q3 2015
- G4-IRD and AUD-IRD clearing mandate for non-dealer non-financial counterparties trading over a specified gross notional threshold (per asset class): Q1 2016

9. What do you view as the characteristics that make a trading platform suitable for mandatory trading of derivatives?

Response to question 9: Given the state of electronic platform trading globally, it is important to provide the local market with a platform that offers both Request-For-Quote (RFQ) and Central Limit Order Book (CLOB) functionalities so that participants may utilise them as required in the long term. Currently, the RFQ model has been much more prevalent in the global OTC markets so it is likely that the CLOB model will not be utilised widely for some time to come.

Pre-trade and post-trade block allocation should also be offered by the platform. Connectivity to credit hubs may also be an important factor, as not many clearing brokers will wish to update their limits at the trading platform directly. The ability to provide sponsored access versus direct access is also key, as smaller market participants will choose sponsored/agency access for ease of trading and to limit their costs.

10. Do you have comments on the proposals relating to:

- *Making the exemption of end users from trade reporting permanent, subject to ensuring that appropriate information on systemically important OTC derivatives trading is available to regulators?*

- *A more tightly targeted AFSL reference in the regulations?*
- *Or is there another option you prefer? If so, why?*

Response to question 10: We agree that it is prudent for the regulation to be amended such that the trade reporting obligation should only be imposed on AFSL holders with respect to the specific derivatives authorized under their AFSL.

With respect to permanent end user exemption from trade reporting, we feel it is important to define the specific methods and ways in which end user trades which may be systemically important to the Australian market will be picked up and tracked by the regulators. In the interest of market transparency, it is key that trends and fluctuations in the end user market are monitored and reported to the regulators for completeness and consistency with the international OTC derivatives markets.

About GreySpark Partners

GreySpark is a global consultancy providing services exclusively to Capital Markets businesses. We are the trusted advisors to the world's leading finance houses. We help the leaders to make substantial, lasting improvements to the performance of their organisations.

We assist our clients throughout business and project lifecycles, from inception to completion, offering services in:

- Business Consulting
- Management Consulting
- Technology

For any questions regarding this submission, please contact Malavika Shekar or Braian Szwarcberg-Poch on +61 2 9299 9298 or at sydney@greyspark.com.

For further information about GreySpark please visit our website: www.greyspark.com.