



Financial System Inquiry 2014

Submission by GreySpark Partners

GreySpark Partners thanks the Australian Treasury for the opportunity to comment on its Financial System Inquiry.

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 submissions and comments, particularly with respect to the terms of reference that address integration with international financial regulation and addressing the effectiveness and need for financial regulation.

OTC derivatives reforms and impact on the buy-side

The implications of the global OTC derivatives reforms triggered by the 2009 G20 commitments are far-reaching. Australia has a distinct advantage due to the fact that it has seen these reforms being rolled out in the U.S. and EU previously and can therefore draw upon the successes and failures of reform implementation in those regions in formulating a plan for Australian reforms.

The approach to regulation in Australia has so far been measured and cautious. The phased approach taken by the Australian Securities and Investments Commission ("ASIC") to mandating reporting to trade repositories has certainly been viewed by the markets 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.

Whilst 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 experience that the buy-side is largely delaying their commitment to and preparation for clearing until a mandate is announced by regulators. The recent 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 buy-side 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 buy-side 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 buy-side 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 relation to the global OTC derivatives clearing landscape, mandatory clearing is already live in the U.S. and is expected to commence in EU in early 2015. From GreySpark's extensive discussions with 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 buy-side clearing mandate until 2016 and instead implement this in late 2015. 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 buy-side firms in Australia enough time to prepare. Buy-side firms who are currently holding off moving forward with clearing arrangements would also then be able to firmly commit to preparing for clearing. This would eliminate much of the uncertainty and confusion that buy-side firms are facing today in relation to future Australian clearing timelines.

Systemic risk - Collateral management

Collateral management for cleared trades is emerging as an area of systemic risk that will require detailed planning and preparation from all market participants. The issue of sourcing quality collateral has become key to clearing readiness, as clearinghouses generally only accept government bonds, treasuries or cash as collateral and most market participants do not hold any of these in quantities that will satisfy daily margin calls from clearinghouses on a long-term basis.

Recent industry papers have predicted that the demand for high-grade collateral will exceed supply in a post-clearing environment and this is a risk that must be considered in the context of the Australian market. During times of extreme stress in the market as seen in 2008, margin calls between clearing counterparties to OTC derivatives trades become more frequent as the value of the collateral held against a trade changes significantly as the market deteriorates further into stress. This can create a cyclical flow of events where firms need to source larger quantities of collateral and post margin more frequently in a volatile and distressed market where quality collateral is scarce. Such a scenario, while rare and infrequent in history, should be considered in how Australian market participants prepare for clearing and global reforms.

Collateral transformation services are evolving in the U.S. and EU regions as a potential solution to this collateral crunch. At a holistic level, collateral transformation involves the exchange of low-grade collateral along with a fee for the high-grade collateral that is necessary to meet



clearinghouse margin requirements. The systemic risk that this process poses is that the process of transforming collateral does not, in theory, have to stop with one transaction – it can be continued as a chain of transactions as the collateral changes hands multiple times. It is important for regulators to have a view into collateral transformation processes as the systemic and operational risks created by excessive collateral transformation have the possibility to undermine the fundamental safety of the overall central clearing model. Over time, as clearing becomes mandated and collateral transformation becomes widespread in the Australian market this may result in the chain of collateral lending lengthening, regulators will need to find ways to keep track of collateral movements, ownership and valuations.