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Thought leadership

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A Smart (Margin) Approach to Blockchain

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Increased margin requirements for uncleared derivatives coming into force over the next few years are forcing firms to re-evaluate their derivatives margining activities and the collateral life cycle. Currently, it takes extensive manual intervention to source and move collateral, resulting in extended timelines, higher costs, human error and valuation disputes. According to the Depository Trust and Clearing Corporation (DTCC) discussions with OTC derivative market participants indicates margin call activity could increase up to 1000%.

That is one reason the industry expects more collateral to be exchanged. With increased reserves needed, banks need to make that process more efficient. They're looking for ways to ease the operational burden, and elevate collateral management to a major business issue with risk management, technology and operational considerations. When doing so, here are four areas they should consider:

- Operations: Using blockchain for collateral management and margin calls may not be for every organization. Banks will need to update existing collateral operations, accounting for regulatory requirements. In doing so, they should consider how their current operating models would handle an increase in margin calls, analyzing how much time it takes now to get one margin call in and the operational and cost impact if 10x more came in? Look at client groups and asset classes where collateral management is the most time-consuming and inefficient, and target those first for implementation of blockchain technology.

- Risk management: Banks should look at the number of disputes they have, where they don't agree with their counterparties on collateral levels to understand whether or not there is a risk issue to solve. If everyone used smart contracts on a private blockchain, it could make it easier to agree on transaction details, valuation models and margin calls.

- Technology: Every bank will ultimately have to figure out how to integrate a full or partial blockchain strategy with their own collateral management system to transform their operations and to keep up with growing collateral demands. Blockchain could augment existing collateral management systems or perhaps replace them.

- Customer Experience: Banks might also think about how to integrate a new smart margin call process into their existing customer portal to enhance the customer experience. This wouldn't necessarily lead to more business with existing clients, but it could be a sales point of differentiation with prospective clients.

A blockchain solution for OTC derivatives margin calls could dramatically enhance collateral management globally and help banks better manage liquidity risk. This also stands to benefit regional banks, leveling the playing field for them to compete with global banks. Those at risk of losing are collateral management software providers and vendors. If banks use integrated systems, then there might not be room for a packaged product anymore. Banks could continue to use existing technology to save short-term costs, but the longer-term cost and risk makes that an in-balanced equation, making it in the best interest of collateral management providers as well to be part of an industry-wide blockchain solution.