The Role of Collateral in Risk Management

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Agenda

- The Importance of Collateral
- How Collateral Mitigates Risk
- Credit Department Risk Analysis
The Importance of Collateral

- Primary objectives:
  - Permits dealings with less creditworthy customers
  - Increases business with more creditworthy customers

- Overall result:
  - Firm’s profit making potential is enhanced
Goldman Sachs’ Balance Sheet

1999 financials tell much of the story:

- Customer and counterparty receivables (includes margin lending) $30.1B
- Securities loaned 9.2B
- Securities purchased via repo* 37.1B
- OTC derivatives-related collateral 6.6B

* Repo transactions (which involve the purchase and agreement to resell securities) do not involve collateral but provide some similar risk mitigation benefits.
Goldman Sachs’ Income Statement

1999 net revenues of $13.3B include:

- Fixed Income, Currencies & Commodities Trading $2.9B
- Equities Trading $2.0B
  $4.9B

Our willingness to accept collateral from customers is one driver of the firm’s revenue generation capability.
The Product Perspective

- Fixed Income
  - Repos*, securities lending, swaps, options and futures
- Currencies
  - Forward contracts, swaps, options and futures
- Commodities
  - Forward contracts, swaps, options and futures
- Equities
  - Margin lending, stock lending, derivatives, options and futures

* Repo transactions (which involve the purchase and agreement to resell securities) do not involve collateral but provide some similar risk mitigation benefits.
How Collateral Mitigates Risk

- **Variation Margin**: Marking-to-market and the resulting collateral call reduces and often eliminates existing unsecured credit risk.

- **Initial Margin**: For some customers, an additional cushion of collateral is taken upfront to protect against any potential future mark-to-market exposure.
Credit Department Risk Analysis

Three specific risks:

- **Credit risk**: how much unsecured credit exposure is acceptable for a customer?
- **Collateral risk**: what is the likelihood that the collateral will decrease in value or will not be easily marketable?
- **Legal risk**: is there a risk of delay on a sale of the collateral or a risk of challenge on the rights to collateral?