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OCC Reports Derivatives Volume Falls Below $50 Trillion

WASHINGTON -- U.S. commercial banks saw earnings from cash instruments and derivatives activities drop $805 million, to $2.65 billion, in the fourth quarter of 2001, while the notional value of derivatives fell by $5.9 trillion, to $45.4 trillion.

The drop in the notional value of derivatives from the previous three months was attributable to the merger of Chase Manhattan Bank and Morgan Guaranty Trust Co.

Despite the elimination of contracts between those two large institutions, derivatives activities at U.S. banks rose slightly during the quarter, said Michael L. Brosnan, the OCC's Deputy Comptroller for Risk Evaluation.

"The notional volumes at the other U.S. banks engaged in derivatives transactions increased $1 trillion during the quarter, reflecting the continued interest by customers of banks in risk management products," Mr. Brosnan said.

In its fourth quarter report on bank derivatives, which was released today, the Office of the Comptroller of the Currency noted that while the notional amount of derivatives is a reasonable reflection of business activity, it is not an amount at risk. The risk in a derivatives contract is a function of a number of variables, such as whether counterparties exchange notional principal, the volatility of the currencies or interest rates used as the basis for determining contract payments, the maturity and liquidity of contracts, and the creditworthiness of the counterparties in the transaction.

The report noted that total credit exposure, which consists of both the current mark-to-market exposure, as well as potential future exposure, decreased $77 billion in the fourth quarter to $482 billion. Total credit exposures for the top seven banks decreased to 158 percent of risk-based capital in the fourth quarter of 2001 from 322 percent in the third quarter.

"The significant decline in notional volumes was the primary reason that current mark-to-market

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exposure declined $19 billion and potential future exposure decreased $58 billion," Mr. Brosnan said.

During the fourth quarter of 2001, banks charged-off $296 million from credit exposures associated with derivatives.

"We expected charge-offs to begin to rise as the downturn translated into corporate bankruptcies and defaults," Mr. Brosnan said. "Most large companies use derivatives, so even though banks have collateral on lower rated exposures, the probability for charge-offs increases during economic downturns. Thus far, losses are very small relative to bank earnings and capital levels."

The report showed that derivative contacts 30 days or more past due amounted to only $116 million or .024 percent of total credit exposure from derivative contracts.

During the fourth quarter, the notional amount of interest rate contracts decreased by $4.8 trillion, to $38.3 trillion. Foreign exchange contracts decreased by $906 billion to $5.7 trillion. This figure excludes spot foreign exchange contracts, which decreased by $285 billion to $111 billion. Equity, commodity and other contracts dropped by $186 billion to $950 billion. Credit derivatives increased $35 billion to $395 billion.

Overall, 84 percent of the notional amount of derivative positions was comprised of interest rate contracts with foreign exchange accounting for an additional 13 percent. Equity, commodity and credit derivatives accounted for only three percent of the total notional amount.

"The recent spate of corporate bankruptcies have shown just how important credit derivatives can be as a risk hedging tool," Mr. Brosnan said. "A number of banks have collected on these contracts, reducing the severity of the downturn's impact on their overall asset quality. Contracts that triggered payments have been settled fairly smoothly, a further positive sign for that market's development."

The top seven commercial banks engaged in derivatives trading account for 96 percent of the total notional amount of derivatives in the commercial banking system, with more than 99 percent held by the top 25 banks.

The OCC's fourth quarter report on derivatives also noted that:

- Revenues from interest rate positions decreased by $271 million from the previous quarter, to $1.3 billion, while revenues from foreign exchange positions decreased by $534 million from the prior three months, to $967 million. Revenue from equity, commodity and other trading positions remained flat at $390 million.

- Long-term contracts (maturity of five years or more) decreased from the third quarter by $1.9

trillion to $8 trillion. Notional amounts for contracts with maturities of one to five years fell in the fourth quarter by $1.1 trillion to $12.7 trillion. Short-term (less than one year) contract notional volumes also decreased by $1.7 trillion to $14.3 trillion.

- The number of commercial banks holding derivatives increased by 10 to 369.

A copy of *OCC Bank Derivatives Report: Fourth Quarter 2001* is available on the OCC Web site: www.occ.treas.gov.

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