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OCC Reports Derivatives Volume Tops $50 Trillion

WASHINGTON—Derivatives held by U. S. commercial banks increased $3.8 trillion in the second quarter 2002, to $50.1 trillion, the second highest amount ever recorded, the Office of the Comptroller of the Currency reported today in its quarterly *Bank Derivatives Report*.

"All of the corporate governance issues that have dominated the business pages over the past few months created greater uncertainty in the financial markets," said the OCC's Michael L. Brosnan. "Risk managers typically respond to greater uncertainty by reshaping their risk profiles, and that explains the fairly sharp rise in derivative notional volumes during the second quarter."

The OCC also reported that earnings attributable to the trading of cash instruments and derivatives activities increased by $225 million in the three-month period, to $3.4 billion. "This is the first time since we've been looking at the data that second quarter revenues increased from the first quarter," said Mr. Brosnan, a member of OCC's Large Bank Group and outgoing Deputy Comptroller for Risk Evaluation. "The big increase in notional volumes drove revenues, and so we didn't see the typical second quarter decline in revenues." Revenues from interest rate positions increased $60 million to $1.6 billion, while revenues from foreign exchange positions increased $132 million to $1.3 billion. Revenues from equity activities increased $83 million to $490 million.

Mr. Brosnan pointed out that while the near-record notional amount of derivatives is a reasonable reflection of business activity, it does not represent the amount at risk for commercial banks. "The primary risk in an over-the-counter derivatives contract is credit risk," said Mr. Brosnan.

The report noted that total credit exposure, which consists of both the netted current mark-to-market exposure, as well as potential future exposure, increased $79.6 billion to $525 billion. "The big decline in interest rates during the quarter caused a pretty sharp increase in credit exposures," said Mr. Brosnan. "We expected this. Almost 60% of the notional volumes outstanding are swaps, and the lion's share of that is for interest rates. When rates fall, contracts where the bank receives a fixed rate go up in value and that gives higher credit exposures."

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Mr. Brosnan noted that there is an offset to the higher credit risk numbers. "Contracts where the bank pays a fixed rate go down in value when rates fall, and that means the bank owes money to its clients. The amount that banks owe to their clients matches up pretty well with the amounts their clients owe them," he said. Gross positive fair values for the seven largest derivatives dealers totaled $718 billion in the second quarter, compared to gross negative fair values of $703 billion.

Mr. Brosnan reported that the "credit quality of derivative exposures is holding up quite well given the economic climate and large, well publicized, corporate bankruptcies." Charge-offs on derivatives exposures totaled $25 million during the second quarter, down from $68 million in the first quarter. "Charges-offs of derivatives exposures are much lower than on loan portfolios," Mr. Brosnan said. Banks charged off .005 percent of the total credit exposure from derivative contracts in the second quarter, compared to .82 percent for C&I loans. "We still don't think we're out of the woods yet on charge-offs, but the second quarter performance is certainly encouraging," he said.

During the second quarter, the notional amount of interest rate contracts increased by $3.4 trillion, to $42.7 trillion. Foreign exchange contracts increased by $183 million, to $5.8 trillion. This figure excludes spot foreign exchange contracts, which increased by $332 billion, to $504 billion. Equity, commodity and other contracts increased by $85 billion, to $1.1 trillion. Credit derivatives increased by $54 billion, to $492 billion.

The OCC second quarter derivates report also noted that:

- 85 percent of the notional amount of derivative positions was comprised of interest rate contracts with foreign exchange accounting for an additional 12 percent. Equity, commodity and credit derivatives accounted for only 3 percent of the total notional amount.

- Long-term contracts (those with maturities of five years or more) increased by $796 billion, to $8.9 trillion. Contracts with remaining maturities of one to five years grew by $1 trillion to $14.4 trillion. Short-term contracts (those with maturities of less than one year) increased by $1.4 trillion to $16.1 trillion.

- The number of commercial banks holding derivatives increased by 12, to 391.

A copy of *OCC Bank Derivatives Report: Second Quarter 2002* is available on the OCC Web site: www.occ.treas.gov.

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