



NEWS RELEASE

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OCC Reports Derivatives Volume Tops \$67 Trillion

WASHINGTON—Derivatives held by U. S. commercial banks increased \$1.3 trillion in the third quarter, to \$67.1 trillion, the Office of the Comptroller of the Currency reported today in its quarter *Bank Derivatives Report*.

“The strong growth in derivatives notionals that we have seen for the past few quarters took a bit of breather in the third quarter, said Kathryn E. Dick, the OCC’s Deputy Comptroller for Risk Evaluation. Ms. Dick noted that notional contracts increased only 1.9%, the smallest percentage increase since a decline in such contracts in the fourth quarter of 2001. “Much of the risk management actions in response to the sudden and sharp rise in interest rates in the second quarter appears to have occurred prior to the start of the third quarter,” Ms. Dick said. When used properly, derivatives are a valuable risk management product to help bank institutional customers manage a broad array of different risks arising from common business activities such as securing long-term funding or protecting the value of importing or exporting commercial goods.

Ms. Dick noted that the notional amount of derivatives outstanding, notwithstanding modest third quarter growth, is a new record. While notional amounts are a reasonable reflection of business activity, they do not represent the amount at risk for commercial banks. 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 OCC also reported that earnings attributable to the trading of cash instruments and derivatives activities decreased by \$150 million in the three-month period, to \$3 billion. Commercial bank trading revenues reflect profit and loss from derivatives and cash trading.

“The third quarter revenue numbers were reasonably strong, particularly given the soft growth in notionals and the continued tightening of credit spreads,” said Ms. Dick. Ms. Dick noted, “The ongoing tightening in credit spreads, which began late last year, reflects the general market sentiment of improving asset quality. However, when credit spreads tighten, banks lose value in the contracts they own that hedge credit risks in their loan portfolios and this serves to depress trading revenues. This headwind continues to exert a negative impact on trading revenues, but its impact appears to be diminishing.”

The report also noted that total credit exposure, in the third quarter decreased. “There are two pieces to the total credit exposure number. The first piece is current credit exposure, which represents the

mark-to-market gain on contracts with clients, net of losses on contracts to those same clients where the bank has legally enforceable netting agreements. The rise in interest rates finally checked the growth in current credit exposures, which fell \$30 billion. The second piece is potential future exposure, or PFE, which is a function of the type of derivative contract and its maturity. Because notional volumes continued to increase, this PFE increased \$24 billion, leaving a net \$6 billion reduction in total credit exposure,” said Ms. Dick. The concentration of interest rate contracts in bank trading portfolios results in credit exposure calculations that are highly sensitive to changes in interest rates.

Credit risk performance indicators confirmed the positive view of credit quality as reflected by narrowing corporate credit spreads. The report noted that only a small fraction of derivatives contracts were 30 days or more past due. For all banks, the fair value of contracts past due 30 days or more totaled only \$56 million, or .008 percent of total credit exposure from derivative contracts. Derivatives charge-offs for the quarter were \$32 million, and represent .0045 percent of total derivative exposures, well below the .31 percent for C&I loans.

During the third quarter, the notional amount of interest rate contracts increased by \$1.3 trillion, to \$58.3 trillion. Foreign exchange contracts decreased by \$181 billion to \$6.9 trillion. This figure excludes spot foreign exchange contracts, which increased by \$43 billion, to \$652 billion. Equity, commodity and other contracts increased by \$47 billion, to \$1.1 trillion. Credit derivatives increased by \$67 billion, to \$869 billion.

The derivatives business remains largely concentrated in interest rate contracts. Overall, 87 percent of the notional amount of derivatives positions was comprised of interest rate contracts, with foreign exchange accounting for an additional 10 percent. Equity, commodity and credit derivatives accounted for only three percent of the total notional amount.

The number of commercial banks actively engaging in derivatives remains small. The top seven commercial banks account for almost 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. “These large players have the most sophisticated risk management systems, high caliber management, and are subject to close supervision from bank regulators,” said Ms. Dick.

The OCC third quarter derivatives report also noted that:

Interest rate revenues decreased by \$266 million in the third quarter to \$1.2 billion. Revenues from foreign exchange positions decreased by \$78 million, to \$1.4 billion. Revenues from equity trading positions decreased by \$1 million, to \$299 million in the third quarter. Revenues from commodity and other trading positions increased by \$195 million to \$78 million, reversing a net loss of \$117 million in the second quarter.

The number of commercial banks holding derivatives increased by 42, to 572.

A copy of *OCC Bank Derivatives Report: Third Quarter 2003* is available on the OCC Web site: www.occ.treas.gov.

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The OCC charters, regulates and examines approximately 2,100 national banks and 52 federal branches of foreign banks in the U.S., accounting for more than 55 percent of the nation’s banking assets. Its mission is to ensure a safe and sound and competitive national banking system that supports the citizens, communities and economy of the United States.

