

NR 96-97
September 13, 1996

Derivatives Activity Jumped \$1.2 Trillion In 2nd Quarter
To Record Level Of \$19 Trillion

WASHINGTON, D.C. -- The amount of bank derivatives activity increased significantly in the second quarter of 1996, rising by \$1.2 trillion to a record \$19 trillion, the Office of the Comptroller of the Currency (OCC) announced today. The notional amount of derivatives activity has more than doubled since the end of 1992, when it stood at \$8.8 trillion.

For the nine largest banks that dominate the U.S. derivatives market, the average percentage of credit exposure to risk based capital rose in the second quarter to 244 percent. These nine banks account for 94 percent of the total notional amount of derivatives in the banking system. The number of banks holding derivatives decreased by 42 in the second quarter to 507.

With trading revenue from interest rate contracts leading the way, total trading revenue in the second quarter was \$1.9 billion, down slightly from the record \$2 billion the quarter before.

The OCC reports quarterly on the status of U.S. derivatives activity. Following is a summary of the report:

Derivatives Activity: The notional amount of bank derivatives activity rose by \$1.2 trillion in the second quarter to \$19 trillion. The notional amounts of interest rate and foreign exchange contracts, which account for 98 percent of all derivatives activity, rose to \$12.5 trillion and \$6.1 trillion respectively. Segregated by type, \$8.1 trillion in second quarter derivatives transactions were futures and forward trades; \$6.7 trillion were swaps; and \$4.2 trillion were options.

Risk Exposure: The average percentage of credit exposure to risk based capital for the top 9 banks with derivatives rose in the second quarter to 244 percent. The increase in credit risk exposure during the second quarter is largely due to the growth in derivatives volumes and the related increase in the future add-on portion of the credit exposure calculation. Credit exposure would have been significantly higher without the benefit of bilateral netting agreements. Non-performing contracts remained low, with the book value of contracts past due 30 days or more totaling only \$16 million.

Revenues: Trading revenue declined by \$62 million to \$1.9 billion in the second quarter, a 3 percent drop from the first quarter. The top nine banks involved in derivatives trading realized 86 percent of the nearly \$2 billion in revenue during the second quarter. A third of trading revenues from cash and derivatives activities was attributable to Morgan Guaranty Trust, which realized \$634 million. These revenue data include both cash and derivatives trading activities.

High-Risk Mortgage Securities/Structured Notes: Banks reporting either structured notes or high-risk mortgage securities were largely those banks with total assets of less than \$1 billion. The book value of these instruments exceeded the market value by \$349 million, a deterioration of \$151 million from the first quarter. The number of banks reporting structured notes on their books decreased in the second quarter by 196 to 3,850.

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The OCC charters, regulates and examines approximately 2,800 national banks and 66 federal branches and agencies of foreign banks in the U.S., accounting for more than half the nation's banking assets. Its mission is to ensure the safety and soundness of the national banking system.

FACT SHEET
DERIVATIVES DATA - SECOND QUARTER 1996 CALL REPORT

GENERAL

The notional amount of derivatives in commercial bank portfolios increased by \$1.2 trillion in the second quarter to \$19 trillion. (This figure excludes spot foreign exchange contracts, which decreased by \$2.5 billion to \$560 billion). During the second quarter, the notional amount of interest rate contracts rose by \$698 billion, to \$12.52 trillion. Foreign exchange contracts increased by \$476 billion, to \$6.13 trillion, while commodity and equity contracts increased by \$16 billion, to \$394 billion. The number of commercial banks holding derivatives decreased by 42 in the second quarter to 507. [See Tables 1, 2, and 3, Graphs 1 and Graph 3.]

Approximately 66 percent of the notional amount of derivative positions was comprised of interest rate contracts with an additional 32 percent represented by foreign exchange contracts. Commodity and equity contracts accounted for only 2 percent of the total notional amount. The composition of contract types remains relatively unchanged since 1991. [See Table 3 and Graph 3.]

Off-balance sheet derivatives continue to be concentrated in the largest banks. Nine commercial banks account for 94 percent of the total notional amount of derivatives in the banking system, with 98 percent accounted for by the top 25 banks (these figures include spot foreign exchange). [See Table 3 and Graph 4 for concentrations excluding spot foreign exchange.]

Over-the-counter (OTC) and exchange-traded contracts comprised 86 percent and 14 percent, respectively, of the notional holdings as of second quarter, which is virtually the same as first quarter 1996. [See Table 3.] OTC contracts tend to be more popular with banks and bank customers because they can be tailored to meet firm-specific risk management needs. However, OTC contracts tend to be less liquid than exchange-traded contracts, which are

standardized and fungible.

The notional amounts of short-term (i.e., with remaining maturities of less than one year) contracts are up \$509 billion from the first quarter, to \$9.27 trillion. Contracts with remaining maturities of one to five years increased by \$179 billion, to \$4.11 trillion, and long-term (i.e., with maturities of five or more years) contracts increased by \$105 billion, to \$1.09 trillion. [See Tables 10, 11 and 12, Graphs 7, 8 and 9.]

RISK

Notional amounts are helpful in measuring the level and trends of derivatives activity. However, these amounts may be misleading indicator of risk exposure. Beginning in the second quarter of 1995, the Call Report provided data that improve disclosure and understanding of the relative riskiness of bank activities involving derivatives. Some of the data provide immediate information (e.g., fair values and credit risk positions) while other data will be more useful over time in evaluating trends (e.g., revenue and contractual maturity data).

In addition to the Call Report changes, the risk-based capital guidelines were amended as of the second quarter of 1995 to (1) revise and expand the set of conversion factors used to calculate the potential future credit exposure of derivative contracts, and (2) recognize the effect that qualifying bilateral netting arrangements will have on the potential future credit exposure for derivative contracts. Contracts with the longest maturities (i.e., over five years) are now subject to new, higher conversion factors. New conversion factors were also established that specifically apply to derivative contracts related to equities, precious metals, and other commodity contracts. The credit exposure calculations in Table 4 reflect those new factors. However, that table does not reflect the effects of bilateral netting on potential future credit exposures. Under the new risk-based capital guidelines, banks have the option of either calculating their netted potential future credit exposure on a counterparty basis or approximating their netted potential future credit exposure on an aggregate basis (so long as the method chosen is used consistently and is subject to examiner review). Since available Call Report information does not reveal the method chosen by the bank to report the impact of netting on future credit exposure, the total credit exposures reported here represent upper bounds. If a bank has a legally valid bilateral netting arrangement, potential future credit exposure could be decreased.

The second quarter saw a \$13 billion increase in total credit exposure from off-balance sheet contracts to \$235 billion. Relative to risk-based capital, total credit exposures for the top nine banks averaged 244.1 percent of capital in the second quarter, compared to 233.7 percent at the end of the first quarter. This increase in exposure is largely due to the growth in derivative volumes and the related increase in the future add-on portion of the credit exposure calculation. However, credit exposure would have been significantly higher without the benefit

of bilateral netting agreements. The extent of the benefit can be seen by comparing the gross positive replacement cost from Table 6 to the bilaterally-netted current exposures shown on Table 4. [See Table 4, Table 6, Graph 5a and Graph5b.]

Non-performing contracts remained at nominal levels. For all banks, the book value of contracts past due 30 days or more aggregated only \$16 million, or .0001 percent of total current exposure from derivatives contracts. As of the second quarter 1996, banks with derivative contracts reported \$19 million in credit losses from off-balance sheet derivatives. This number represents the year-to-date charge-offs incurred from off-balance sheet contracts. These figures reflect both the current healthy economic environment and the relatively high credit quality of counterparties and end-users with whom banks currently engage in derivatives transactions.

The Call Report data reflect the significant differences in customer bases and business strategies among the banks. The preponderance of trading activities, including both customer transactions and proprietary positions, is confined to the very largest banks. Smaller banks tend to limit their use of derivatives to risk management transactions. The banks with the 25 largest derivatives portfolios hold 93.6 percent of the contracts for trading purposes, primarily customer service transactions, while the remaining 6.4 percent are held for their own risk management needs. The trading contracts of these banks represent 91.5 percent of all notional values in the commercial banking system. Banks below the top 25, which use derivatives primarily for risk management transactions, hold 72.7 percent of their contracts for purposes other than trading. [See Table 5]

The gross negative and gross positive fair values of derivatives portfolios show that banks continue to maintain relatively balanced books; that is, the value of positions in which the bank has a gain is not significantly different from the value of those positions with a loss. In fact, the nine largest banks have \$198.4 billion in positive fair values and \$198.3 billion in negative fair values. These figures represent a slight increase from first quarter levels. Note that while gross fair value data are very useful in depicting more meaningful market risk exposure, users must be cautioned that these figures do not include the results of cash positions in trading portfolios. Similarly, the data are reported on a legal entity basis and consequently do not reflect effects of positions in portfolios of affiliates, and may result in double-counting bank and non-bank affiliate positions.

End-user positions, or derivatives held for risk management purposes, have aggregate gross positive fair values of \$8.3 billion, while the gross negative fair value of these contracts aggregated to \$9.5 billion. Readers must be cautioned, however, that these figures are only useful in the context of a more complete analysis of each bank's asset/liability structure and management process. [See Table 6.]

REVENUES

The Call Report data include revenue information regarding cash and derivative trading activities. The data also show the impact on net interest income and non-interest income from derivatives used in non-trading activities. Note that the revenue data reported in Table 7 and Graph 6 reflect figures for the second quarter alone, and are not annualized.

The revenue figures reported for trading activities in the second quarter of 1996 indicate that the banks with traded derivatives realized approximately \$2 billion from cash and off-balance sheet derivative contracts, with the top 9 banks accounting for 86.1 percent of these trading revenues. Relative to the first quarter of 1996, the second quarter of 1996 resulted in a small decrease in trading revenues from cash and derivatives activities of \$62 million, or 3.1 percent. As with the first quarter of 1996, over one third of trading revenues from cash and derivatives activities are attributable to Morgan Guaranty Trust, which realized \$634 million.

In the second quarter, revenues from interest rate contracts fell \$207 million, to \$951 million, while revenues from foreign exchange contracts increased \$104 million, to \$733 million. Revenue from other trading contracts, including equities and commodities contracts, rose \$42 million, generating \$233 million in revenues; with virtually all of that amount was in the top nine banks. [See Table 7, Graph 6]

Derivatives held for purposes other than trading did not have a significant impact on either net interest income or non-interest income in the second quarter. Non-traded derivatives contributed \$802 million, or 1.1 percent to the \$74.6 billion in gross revenues of banks with derivative contracts in the second quarter. These figures reflect an increase of \$303 million from the first quarter. Readers must be cautioned that these results are only useful in the context of a more complete analysis of each bank's asset/liability structure and management process.

HIGH-RISK MORTGAGE SECURITIES AND STRUCTURED NOTES

The number of banks reporting either structured notes or high-risk mortgage securities remain largely confined to banks with total assets less than \$1 billion. The second quarter aggregated numbers indicate that book values exceeded market values (fair values) by \$96 million for high risk mortgage securities, an \$84 million dollar deterioration from the first quarter. Book values exceeded market values by \$253 million for structured notes, a \$67 million dollar deterioration from the first quarter. This overall depreciation from first to second quarter stems from the rise in market interest rates in the second quarter. For all banks with high-risk mortgage securities, the average book value of holdings relative to total assets for the second quarter of 1996 was 1.3 percent, compared to 1.4 percent in the first quarter of 1996. Average depreciation to capital was .83 percent, compared to .52 percent in the first quarter.

For banks with structured notes, the average book value of holdings to total assets declined slightly to 2.4 percent, compared to 2.5 percent in the first quarter, while average depreciation to capital increased slightly, to .68 percent, compared to .60 percent in the first quarter. The number of banks reporting high-risk mortgage securities decreased by 6 to 535, in the second quarter. The number of banks reporting structured notes on their books decreased in the second quarter by 196, to 3,850. [See Table 8 and Table 9, Graphs 10 and 11.]

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GLOSSARY OF TERMS

Bilateral Netting: A legally enforceable arrangement between a bank and a counterparty that creates a single legal obligation covering all included individual contracts. This means that a bank's obligation, in the event of the default or insolvency of one of the parties, would be the net sum of all positive and negative fair values of contracts included in the bilateral netting arrangement.

Derivative: A financial contract whose value is derived from the performance of assets, interest rates, currency exchange rates, or indexes. Derivative transactions include a wide assortment of financial contracts including structured debt obligations and deposits, swaps, futures, options, caps, floors, collars, forwards and various combinations thereof.

Exchange-Traded Derivative Contracts: Standardized derivative contracts transacted on an organized exchange and which usually have margin requirements.

Gross Negative Fair Value: The sum total of the fair values of contracts where the bank owes money to its counterparties, without taking into account netting. This represents the maximum losses the bank's counterparties would incur if the bank defaults and there is no netting of contracts, and no bank collateral was held by the counterparties.

Gross Positive Fair Value: The sum total of the fair values of contracts where the bank is owed money by its counterparties, without taking into account netting. This represents the maximum losses a bank could incur if all its counterparties default and there is no netting of contracts, and the bank holds no counterparty collateral.

High-Risk Mortgage Securities: Securities where the price or expected average life is highly sensitive to interest rate changes, as determined by the FFIEC policy statement on high-risk mortgage securities. See also OCC Banking Circular 228 (rev.)

Off-Balance Sheet Derivative Contracts: Derivative contracts that generally do not involve booking assets or liabilities (i.e., swaps, futures, forwards, and options).

Over-the-Counter Derivative Contracts: Privately negotiated

derivative contracts that are transacted off organized exchanges.

Structured Notes: Non-mortgage-backed debt securities, whose cash flow characteristics depend on one or more indices and/or have embedded forwards or options.

Total Risk-Based Capital: The sum of tier 1 plus tier 2 capital. Tier 1 capital consists of common shareholders equity, perpetual preferred shareholders equity with noncumulative dividends, retained earnings, and minority interests in the equity accounts of consolidated subsidiaries. Tier 2 capital consists of subordinated debt, intermediate-term preferred stock, cumulative and long-term preferred stock, and a portion of a bank's allowance for loan and lease losses.