



# NEWS RELEASE

Comptroller of the Currency  
Administrator of National Banks

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## OCC Reports Derivative Volume Surpasses \$70 Trillion

WASHINGTON—Derivatives held by U. S. commercial banks increased \$3.9 trillion in the fourth quarter, to \$71.1 trillion, the Office of the Comptroller of the Currency reported today in its quarterly [Bank Derivatives Report](#).

“Following a lull in the third quarter, bank derivatives activity returned to a more normal level before the end of the year,” said Kathryn E. Dick, the OCC’s Deputy Comptroller for Risk Evaluation. Ms. Dick noted that most of the notional growth occurred in interest rate swaps, a favored tool by risk managers seeking to adjust exposures to interest rate risk. “The up tick in interest rates last year appears to have sobered risk managers to the reality that interest rates don’t move in just one direction. Uncertainty tends to create demand for risk management solutions.” 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 at the end of 2003 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 \$902 million in the three-month period, to \$2.1 billion. Commercial bank trading revenues reflect profit and loss from both derivatives and cash trading activities. “There is a bit of a seasonal pattern to revenues. The first quarter is typically very strong and the fourth quarter tends not to be. In five of the past eight years, revenues in the fourth quarter were the weakest of the year, and this was true again in 2003,” said Ms. Dick.

She noted that revenues remain depressed by ongoing tightening in credit spreads, which began late in 2002. “The good thing about tightening credit spreads is that this trend suggests that market participants are confident of continued improvement in asset quality,” said Ms. Dick.

“However, because of accounting rules that treat hedges and the underlying loan assets differently, tightening spreads cause banks to lose value in the contracts they use to hedge credit risks in their loan portfolios, and this affected trading revenues throughout the year.”

The report also noted that total credit exposure increased 5.2% in the fourth quarter to \$755 billion. Total credit exposure has two components: current credit exposure and potential future exposure. 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, increased 4.8% to \$217 billion. “The current credit exposure is a measure of the amount banks have at risk today,” said Ms. Dick. “However, it’s a measure that overstates actual risk, because it doesn’t include collateral held by banks against those current exposures.”

Potential future exposure (PFE), the amount the current credit exposure might become over time, increased 5.4% to \$538 billion. “Notionals went up, and because the PFE is largely a function of notional volumes, it too went up,” said Ms. Dick. “Like current credit exposure, the PFE measure also tends to overstate credit risk. Banks report PFE based upon the exposure that can occur over the full life of the contract, using supervisory risk-based capital standards. However, for most large client relationships, banks have the ability to close out the contracts if the client fails to post collateral when required. A more accurate assessment of the PFE for most large relationships, such as those between dealers, would be the relatively short period of time, generally not more than a month, that represents the time that passes between when a client fails to post collateral until the bank can close out the relationship.” Ms. Dick noted that OCC resident examiners at the largest national banks include monitoring of counterparty exposure levels and risk management practices in their on-going supervision strategies.

During the fourth quarter, the notional amount of interest rate contracts increased by \$3.6 trillion, to \$61.9 trillion. Foreign exchange contracts increased by \$271 billion to \$7.2 trillion. This figure excludes spot foreign exchange contracts, which decreased by \$379 billion, to \$273 billion. Equity, commodity and other contracts decreased by \$16.1 billion, to \$1 trillion. Credit derivatives increased by \$132 billion, to \$1 trillion.

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 \$569 million in the fourth quarter to \$669 million. Revenues from foreign exchange positions decreased by \$252 million, to \$1.2 billion. Revenues from equity trading positions decreased by \$42 million, to \$257 million in the fourth quarter. Revenues from commodity and other trading positions decreased by \$38 million to \$40 million.
- The number of commercial banks holding derivatives increased by 1, to 573.

A copy of *OCC Bank Derivatives Report: Fourth Quarter 2003* is available on the OCC Web site: [www.occ.treas.gov](http://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.