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Administrator of National Banks

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OCC Reports Derivatives Volume Tops $84 Trillion

WASHINGTON—Derivatives held by U. S. commercial banks increased $3.2 trillion in the third quarter, to $84 trillion, the Office of the Comptroller of the Currency reported today in its quarterly *Bank Derivatives Report*.

Kathryn Dick, the OCC's Deputy Comptroller for Risk Evaluation, noted that the notional amount of derivatives outstanding is a new record. Ms. Dick noted that while "notional volumes are a useful indicator of business activity, they don't tell us much about risk, since notional amounts are seldom exchanged in bank derivative contracts." The risk in a derivatives contract is a function of a number of variables, such as whether counterparties exchange notional principal, and the volatility of the market factor used to determine contract payments. The risk in a derivative contract also is a function of the maturity and liquidity of contracts, and the creditworthiness of the counterparties in the transaction.

The report also noted that total credit exposure, the sum of netted current exposure plus potential future exposure, increased $52 billion in the third quarter to $804 billion. "While the Federal Reserve continued to raise overnight rates in the third quarter, yields on longer term instruments actually declined modestly during the quarter, and that had the effect of increasing current credit exposures," said Ms. Dick. The mark-to-market gain on derivatives receivables (gross positive fair values), increased $147 billion, or 14.8%, to $1.15 trillion. Banks were able to net $965 billion of the derivatives payables against their derivatives receivables in the third quarter, up from $829 billion in the second quarter. Therefore, netted current credit exposure, which is derivatives receivables minus netting benefits, increased $11 billion to $183 billion.

Potential future exposure (PFE), which is an estimate of how high credit exposure on existing contracts can become over time, increased $41 billion, largely due to increases in the notional amounts of derivatives contracts over 1 year, as well as foreign exchange and commodity contracts with maturities from 1-5 years. The $41 billion increase in PFE plus the $11 billion increase in netted current credit exposure yields the $52 billion increase in total credit exposure.

"By any measure, the credit numbers are large and we monitor these exposures closely," said Ms. Dick. "However, they are based upon the risk-based capital rules used by the banking agencies, and they do tend to overstate the actual amount of credit risk." Ms Dick explained that both the current credit and potential future exposure numbers do not

take into consideration mitigating factors. "Generally, the big dealers tend to have 30-40% of their netted current exposures secured by collateral, largely cash. So, a more accurate assessment of current credit exposures would subtract liquid collateral values." Ms. Dick noted that the PFE numbers are also overstated because they require capital for transactions that might offset each other. In such a case, a default by both counterparties simultaneously can only involve a loss on one of the contracts. Moreover, the PFE data do not consider whether a contract has a large negative value to the bank, in which case the contract may never have positive value. The risk-based capital rules currently require capital as if the transaction had a zero value. "The banking agencies are aware of the deficiencies in the current risk-based capital structure for derivatives. We are participating in an effort to explore possible changes, as part of the process of implementing the new Basel capital framework," said Ms. Dick.

Credit risk performance indicators confirmed the positive view of credit quality as reflected by narrow 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 $41 million, or .005 percent of total credit exposure from derivative contracts. Derivatives charge-offs for the quarter were $91 million, and represent .01134 percent of total derivative exposures, well below the .073 percent for C&I loans.

During the third quarter, the notional amount of interest rate contracts increased by $2.4 trillion, to $73 trillion. The amount of foreign exchange contracts increased by $163 billion, to $7.9 trillion. This figure excludes spot foreign exchange contracts, which decreased by $27 billion, to $645 billion. Equity, commodity and other contracts increased by $165 billion, to $1.3 trillion. Credit derivatives increased by $423 billion, to $1.9 trillion. Ms. Dick noted that growth in credit derivatives was strong for all of the major dealers. "We see continued growth in this market, due to portfolio hedging and client demand for collateralized debt obligations," said Ms. Dick.

The OCC indicated that revenues reported by banks trading cash and derivatives instruments decreased by $1.3 billion in the third quarter, to $1.3 billion. "Similar to what we saw in the second quarter, the third quarter was not a good one for trading revenues," said Ms. Dick. "Our examiners report that trading results were adversely affected by a combination of weak client demand and unfavorable market moves relative to the directional bias in their trading books." Additionally, Ms. Dick noted that the trading results continue to be adversely influenced by non-trading activity, such as credit derivative hedges of loan portfolio exposures.

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 9 percent. Equity, commodity and credit derivatives accounted for the remaining four percent of the total notional amount.

The OCC third quarter derivatives report noted that the number of commercial banks holding derivatives increased by 30, to 667.

A copy of *OCC Bank Derivatives Report: Third Quarter 2004* is available on the OCC Web site: www.occ.treas.gov.

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The OCC charters, regulates and examines approximately 2,000 national banks and 51 federal branches of foreign banks in the U.S., accounting for more than 56 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.