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Contact: Robert M. Garsson
(202) 874-5770

OCC Reports Derivatives Volume Over $60 Trillion

WASHINGTON—Derivatives held by U. S. commercial banks increased $5.3 trillion in the first quarter, to $61.4 trillion, the Office of the Comptroller of the Currency reported today in its quarterly *Bank Derivatives Report*.

"All market participants have risks they have to manage," said Kathryn E. Dick, the OCC's Deputy Comptroller for Risk Evaluation. "When used properly, derivatives are a valuable risk management tool 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 while the record notional amount of derivatives is a reasonable reflection of business activity, it does 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 increased by $1.2 billion in the three-month period, to $3 billion.

"As is typically the case, first quarter revenues were strong," noted Ms. Dick. "However, actual trading profitability is understated due to risk management adjustments. The most significant revenue adjustment arises from the impact of continued tightening of credit spreads. Narrowing corporate credit spreads reflects reduced investor concern about credit risk, resulting in a decline in the mark-to-market value of credit protection banks have in place. Even though this activity is hedging and not trading, banks typically report the value changes of their credit hedges in trading revenues," said Ms. Dick.

The report also noted that total credit exposure, which consists of both the current mark-to-market exposure (after netting benefits), as well as potential future exposure to counter parties, increased $68 billion to $662 billion. Ms. Dick noted that the calculation used to determine the potential future credit exposure in bank derivatives portfolios is greatly influenced by the current low interest rate environment. "If rates stay at these historically low levels, we expect the credit exposure numbers will remain high. Credit risk is the largest financial risk in commercial bank

derivatives activities, so naturally our examination process focuses on assessing the ability of banks active in derivatives markets to measure, monitor and control credit exposures," Ms. Dick said.

Not withstanding the increase in credit exposure, credit risk performance indicators confirmed the positive view of credit 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 $50 million, or .008 percent of total credit exposure from derivative contracts. Derivatives charge-offs for the quarter decreased $44 million to $30 million, and represent .004 percent of total derivative exposures, well below the .35 percent for C&I loans.

During the first quarter, the notional amount of interest rate contracts increased by $5.1 trillion, to $53.4 trillion. Foreign exchange contracts increased by $167 billion to $6.2 trillion. This figure excludes spot foreign exchange contracts, which increased by $269 billion, to $465 billion. Equity, commodity and other contracts increased by $7 billion, to $1 trillion. Credit derivatives increased by $75 billion, to $710 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," said Ms. Dick. "These large, sophisticated financial institutions are held to the highest credit and liquidity risk management standards," said Ms. Dick.

The OCC first quarter derivatives report also noted that:

Revenues from foreign exchange positions increased by $220 million, to $1.4 billion. Revenues from commodity and other trading positions increased by $25 million to $55 million.

Long-term contracts (those with maturities of five years or more) increased by $954 billion, to $11.2 trillion. Contracts with remaining maturities of one to five years grew by $1.5 trillion to $16.9 trillion. Short-term contracts (those with maturities of less than one year) increased by $1.7 trillion to $19 trillion.

The number of commercial banks holding derivatives increased by 61, to 488.

A copy of *OCC Bank Derivatives Report: First 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.