NEWS RELEASE

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OCC Reports Derivatives Volume Surpasses $65 Trillion

WASHINGTON—Derivatives held by U. S. commercial banks increased $4.4 trillion in the second quarter, to $65.8 trillion, the Office of the Comptroller of the Currency reported today in its quarterly *Bank Derivatives Report*.

"Uncertainty in financial markets continues to drive banks and their customers to seek risk mitigation opportunities through the use of derivatives and the notional numbers this quarter bear that out," said Kathryn E. Dick, the OCC's Deputy Comptroller for Risk Evaluation. "When events such as the sudden rise in long-term interest rates at the end of the last quarter occur, derivatives are often the most efficient and effective tool for rebalancing portfolios." 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 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 $130 million in the three-month period, to $3.2 billion.

"The second quarter revenue numbers were strong, derived primarily from trading activities in interest rate contracts and foreign exchange," noted Ms. Dick. "This is particularly encouraging as actual trading profitability continues to be understated due to risk management adjustments, primarily arising from loan portfolio hedging activities. Credit spreads continued to narrow in the second quarter and as such, banks saw a decline in the mark-to-market value of their credit protection. 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

counterparties, increased $61 billion to $724 billion. "Although interest rates started to increase at the end of the quarter, they were still about 50 basis points lower at the end of the quarter than at the beginning. We expect to continue to see large credit exposure numbers for as long as interest rates remain at historically low levels. The dominance of interest rate contracts in bank trading portfolios results in credit exposure calculations that are highly sensitive to changes in interest rates," said Ms. Dick.

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 $41 million, or .006 percent of total credit exposure from derivative contracts. Derivatives charge-offs for the quarter decreased $4 million to $26 million, and represent .004 percent of total derivative exposures, well below the .34 percent for C&I loans.

During the second quarter, the notional amount of interest rate contracts increased by $3.5 trillion, to $56.9 trillion. Foreign exchange contracts increased by $849 billion to $7.1 trillion. This figure excludes spot foreign exchange contracts, which increased by $144 billion, to $609 billion. Equity, commodity and other contracts decreased by $11 billion, to $1 trillion. Credit derivatives increased by $92 billion, to $802 billion.

The derivatives business remains largely concentrated in interest rate contracts. Overall, 86 percent of the notional amount of derivatives positions was comprised of interest rate contracts, with foreign exchange accounting for an additional 11 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 second quarter derivatives report also noted that:

- Revenues from foreign exchange positions increased by $130 million, to $1.5 billion. Revenues from equity trading positions decreased by $185 million, to $300 million in the second quarter. Revenues from commodity and other trading positions decreased by $172 million to a loss of $117 million.
- The number of commercial banks holding derivatives increased by 42, to 530.

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

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.