NEWS RELEASE

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OCC Reports "More Normal" Derivatives Trading Revenue for Banks

WASHINGTON -- U.S. commercial banks earned $2.8 billion from cash instruments and derivatives activities in the second quarter of 2001, down from the $4.0 billion record revenue of the first quarter. The notional amount of derivatives in insured commercial bank portfolios increased by $3.9 trillion in the first quarter, to $47.8 trillion.

"We expected to see some retrenchment in revenues in the second quarter, and that's exactly what happened," said Michael Brosnan, OCC Deputy Comptroller for Risk Evaluation. "While continued strong corporate debt issuance, and the associated demand for interest rate swaps, underpinned revenue from interest rate derivatives, slowing client demand in other product sectors and less effective positioning resulted in a more normal revenue quarter."

In its *Bank Derivatives Report, Second Quarter 2001*, the Office of the Comptroller of the Currency reported that while the record notional amount of derivatives is a reasonable reflection of business activity, it is an amount at risk. The risk in a derivative 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 credit worthiness of the counterparties in the transaction.

The report noted that total credit exposure, which consists of both current credit exposure as well as potential future exposure, increased $11 billion in the second quarter to $507 billion.

"We continue to pay a lot of attention to the credit exposures," said Mr. Brosnan. "First, credit is the most significant financial risk in this business. Second, the longer tenors of the contracts we see banks booking increases the potential credit exposures. And, of course, the overall economic situation warrants extra vigilance on the part of bankers and regulators. Although the numbers are very large, our examinations have found the quality of counterparty exposures to be reasonably strong and credit risks generally well controlled."

Notwithstanding the overall increase in credit exposures, Mr. Brosnan underscored that "the benefits achieved from legally enforceable netting increased to over 71% and quarterly charge-offs remain small both in dollars and as a percentage of capital."

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The report detailed that derivative contacts past due 30 days or more were only $31 million, a decrease of $18 million from the previous quarter, or .0006 percent of total credit exposure from derivative contracts. During the second quarter of 2001 banks had a net recovery at $1 million from prior quarter credit losses from derivatives.

During the second quarter, the notional amount of interest rate contracts increased by $3.9 trillion, to $39.6 trillion. “The combination of investor demand for fixed rate product and the record issuance of term debt by corporations during the first half of 2001 has spurred growth in interest rate swaps," said Mr. Brosnan.

Foreign exchange contracts decreased by $60 billion to $6.7 trillion. This figure excludes spot foreign exchange contracts, which increased by $30 billion to $440 billion. Equity, commodity and other contracts grew by $53 billion to $1.15 trillion. Credit derivatives fell $1.2 billion to $351 billion. “Credit derivatives were basically flat during the quarter,” Mr. Brosnan said. “That market is just getting over some legal uncertainties related to definitional issues regarding payout events. Additionally, given overall economic concerns, the cost of buying credit protection had increased significantly on many reference entities, which reduced activity. Now that the legal problems appear to be resolved, and the cost of protection has come back down, we expect to see this product begin to grow again.”

The top seven commercial banks engaged in trading account for 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.

The OCC second quarter derivatives report also noted that:

- Revenues from interest rate positions decreased by $509 million, to $1.4 billion, while revenues from foreign exchange positions decreased by $403 million to $.9 billion. Revenue from equity, commodity and other trading positions was $527 million.
- Long-term contracts (maturity of five years or more) increased from the first quarter by $1.0 trillion to $8.6 trillion. Notional amounts for contracts with maturities of one to five years grew in the second quarter by $1.6 trillion to $12.7 trillion. Short-term (less than one year) contract notional volumes decreased by $258 billion to $15.2 trillion.
- The number of commercial banks holding derivatives decreased by 28 to 367.

A copy of *OCC Bank Derivatives Report: Second Quarter 2001* is available on the OCC Web site: www.occ.treas.gov.

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The OCC charters, regulates and examines approximately 2,200 national banks and 56 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.