

**OCC BANK DERIVATIVES REPORT –
FOURTH QUARTER 2002**



Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

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GENERAL

The OCC quarterly report on bank derivatives activities and trading revenues is based on call report information provided by U.S. commercial banks. The notional amount of derivatives in insured commercial bank portfolios increased by \$2.9 trillion in the fourth quarter, to \$56.1 trillion. Generally, changes in notional volumes are reasonable reflections of business activity but do not provide useful measures of risk. During the fourth quarter, the notional amount of interest rate contracts increased by \$2.7 trillion, to \$48.3 trillion. Foreign exchange contracts increased by \$240 billion to \$6.1 trillion. This figure excludes spot foreign exchange contracts, which decreased by \$313 billion to \$196 billion. Equity, commodity and other contracts decreased by \$66 billion, to \$1 trillion. Credit derivatives increased by \$62 billion, to \$635 billion. The number of commercial banks holding derivatives increased by 19, to 427. [See Tables 1, 2, and 3, Graphs 1 and 3.]

Eighty-six percent of the notional amount of derivative positions was comprised of interest rate contracts with foreign exchange accounting for an additional 11 percent. Equity, commodity and credit derivatives accounted for only 3 percent of the total notional amount. [See Table 3 and Graph 3.]

Holdings of derivatives continue to be concentrated in the largest banks. 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. [See Tables 3, 5 and Graph 4.]

Over-the-counter (OTC) and exchange-traded contracts comprised 89 percent and 11 percent, respectively, of the notional holdings as of the fourth quarter of 2002. [See Table 3.] OTC contracts tend to be more popular with banks and bank customers because they can be tailored to meet firm-specific risk management needs. However, OTC contracts expose participants to greater credit risk and tend to be less liquid than exchange-traded contracts, which are standardized and fungible.

The notional amount of short-term contracts (i.e., with remaining maturities of less than one year) increased by \$667 billion to \$17.2 trillion from the third quarter of 2002. Contracts with remaining maturities of one to five years grew by \$775 billion to \$15.5 trillion, and long-term contracts (i.e., with maturities of five or more years) increased by \$1 trillion, to \$10.2 trillion. Longer term contracts present valuable customer service and revenue opportunities. They also pose greater risk management challenges, as longer tenor contracts are generally more difficult to hedge and result in greater counterparty credit risk. [See Tables 8, 9 and 10, Graphs 7, 8 and 9.]

End-user activity decreased by \$276 billion to \$2.1 trillion in the fourth quarter. This decrease is largely attributable to reduced levels of hedging of mortgage servicing rights toward the end of 2002. Prior period declines in end-user activity reflected uncertainties associated with the impact of new accounting standards for derivatives. FAS 133, Accounting for Derivative Instruments and Hedging Activities, became effective for all quarters of all fiscal years beginning after June 15, 2000.

RISK

The notional amount is a reference amount from which contractual payments will be derived, but it is generally not 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. Further, the degree of increase or reduction in risk taking must be considered in the context of a bank's aggregate trading positions as well as its asset and liability structure. Data describing fair values and credit risk exposures are more useful for analyzing point-in-time risk exposure, while data on trading revenues and contractual maturities provide more meaningful information on trends in risk exposure.

Table 4 contains summary data on counterparty credit exposures. The credit exposures shown are measured using the parameters contained in the risk-based capital guidelines of the U.S. banking agencies. There was a \$24 billion increase in the fourth quarter in total credit exposure from derivative contracts, to \$594 billion. Total credit exposures for the top seven banks increased to 198 percent of risk-based capital in the fourth quarter of 2002 from 190 percent in the third quarter. The increase in total credit exposure was centered in a 7.5% increase in future credit exposure to \$375.6 billion, which resulted from the increase in notional amounts, particularly those interest rate contracts with maturities of more than five years. Current credit exposure decreased by \$2 billion in the fourth quarter to \$218.5 billion, as a \$90 billion increase in netting benefits offset an \$88 billion increase in gross positive fair values.

Though total credit exposure increased, without the benefit of netting, it would have been higher. Netting reduced current credit exposures by 81.3 percent in the fourth quarter. [See Tables 4 and 6, Graphs 5a and 5b.]

Past-due derivative contracts remained at nominal levels. For all banks, the fair value of contracts past due 30 days or more aggregated to only \$36 million or .006 percent of total credit