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SPECIAL POLICY BRIEF

"Important New Data on Derivatives"

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This Special Policy Brief is designed to bring to your attention some important new data on derivatives markets. The new data comes from two sources. One is from ISDA (International Swaps and Derivatives Association, Inc. at www.isda.org) on strong growth OTC derivatives activity in the first half of 2003. The other source of data is the BIS (Bank for International Settlements at www.bis.org) which reports even stronger growth in exchange traded derivatives during the same period. For help in interpreting the data and this Brief, see the Primers on Derivatives Instruments and the Glossary at the Financial Policy Forum website (www.financialpolicy.org/dscbrief.htm).

ISDA reports that data collected from their own survey of derivatives markets shows that the amount of outstanding vanilla swaps grew by 25% during the first six months of 2003. The growth rate of all interest rate derivatives, which includes single-currency interest rate swaps, cross-currency interest rate swaps and interest rate options, grew by 24% during the same period. The total outstanding amount of interest rate derivatives now totals $123.9 trillion compared to $99.92 trillion at the end of 2002. By comparison, the BIS reported a figure of $106.29 trillion for the end of 2002. The difference might be attributed to how ISDA surveys only its members while BIS seeks to survey all derivatives dealers worldwide.

ISDA also reports that the volume of outstanding credit derivatives also grew by 25% in the first half of the year, and that outstanding amounts of credit derivatives now totals $2.69 trillion. ISDA shows a much stronger growth in credit derivatives than the O.C.C. data (see FPF Special Policy Brief 8 at www.financialpolicy.org/dscbrief.htm) which reported growth in credit derivatives at U.S. banks of 13.0% -- and a total of $0.802 trillion -- for the first half of 2003. Again the difference is likely due to the differences in the survey population.

A couple of points in the ISDA survey deserve a special mention. They measure this amount in notional value or in other words the quantity of notional principal represented by the OTC derivatives contracts. This is the standard criteria for measuring derivatives trading and outstanding position because it is the most common denominator for summing across types of derivatives contracts. They also describe OTC derivatives and trading activities in derivatives markets as "privately negotiated derivatives." They choose these words carefully because they promote the idea that there is no public interest concern with this activity. Nevertheless, the prices and rates on this private activity can be observed publicly, although not inexpensively, through such live data feeds as Bloomberg. And it can be observed *ex post facto* through H.15 reports by the Federal Reserve Board which considers this activity of such importance that they now report it on along side interest rates on Treasury securities.

The other source of important new data comes from the BIS Quarterly Review of International Banking and Financial Market Developments – www.bis.org/publ/r_qt0309.htm. The BIS data for the first half of 2003 shows strong growth in outstanding amounts of futures and options. The total for futures and options in interest rates, currency and equity indices grew by 32.1%. Interest rate contracts grew by 33.1%, equity index contracts by 20% and currency contracts surged by 40.4%. Of this total, outstanding options showed the fastest growth. Interest rate options grew by 42.1% compared to 20.7% for futures. Geographically, the fastest growth was not in U.S. markets, but Europe where interest rate options volume rose by 73.3%.

In total, the outstanding amount of exchange-traded futures and options reached $38.3 trillion by the mid-year of 2003. And this is a conservatives estimate because it does ***not*** include futures and options on single-stocks or commodities (agriculture, metals or energy), and it does not include any data from dealers that are not reporting banks or securities broker-dealers. This measure of the size of the market, $38,300,000,000,000 or $38.3 trillion, is a very large number. By comparison the value of total output of goods and services in the U.S. – the Gross Domestic Product – is presently $10.79 trillion. Outstanding exchange-traded futures and options positions total three and one-half times the size of the U.S. economy.

The ISDA and BIS information on outstanding amounts can be put together in the following way. If the ISDA figure for growth were used to project forward for mid-year 2003 the BIS for the global OTC derivatives market (i.e. assume 24% growth), then the total size of the global OTC and exchange-traded derivatives markets would reach $214.1 trillion. That would compare with about 20 times the size of the U.S. GDP.

The BIS also reported on the trading volume in exchange-traded futures and options. Measured in notional value, the trading volume across all types of these derivatives increased at 22.4% over the first half of 2003. The total notional amount of these derivatives traded in the first half of the year reached $443.9 trillion, and so at this level of market activity annual trading volume would be $887.9 trillion. That very large number compares to $10.79 trillion size of the U.S. Gross Domestic Product; the trading volume is by that benchmark over 82 times larger than the U.S. GDP.

The trading volume in futures and options on interest rates – which makes up 91.6% of the total – grew by 24.5% in the same period. Like the case for outstanding amounts, the largest growth occurred in options. Similarly, the fastest growth in both futures and options trading occurred in Europe.

The purpose of highlighting this new data is not to alarm but to raise awareness and understanding that these very large markets are growing at a very rapid pace. The data provides further proof that the regulation of financial market regulation by the Sarbanes-Oxley Act is not discouraging the use of derivatives to manage risk. The data also serves as a reminder that derivatives markets are, along with banking, securities and insurance, the pillars of the financial system.