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SPECIAL POLICY BRIEF 24

NEW DERIVATIVES DATA:
DERIVATIVES USE UP BIG AT U.S. BANKS
– JPMORGAN TOPS $45 TRILLION

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The U.S. Treasury Department's Office of Comptroller of the Currency – which is the front line regulator of US chartered banks – recently released quarterly data for year-end 2004 showing that derivatives use by U.S. banks grew by 23.6% in 2004.

Nearly all of that growth was at the five largest banks who make up 96% of all banks' derivatives use. These top five include: J.P.Morgan, Bank of America, Citibank, Wachovia and HSBC-USA. Of the $87.5 trillion of derivatives on the books of US banks, over half – or $44.9 trillion – is held by J.P.Morgan. Bank of America and Citibank are a distant 2nd and 3rd, while the 4th and 5th largest banks each have less than 3.5% of the market.

Most of the growth in derivatives use occurred through the use of over-the-counter swaps contracts – mostly interest rate swaps – whose use rose by 28% to $56.4 trillion.

The OCC's data also shows substantial increases in banks' use of both interest rate and exchange rate derivatives. The use of interest rate derivatives – including all structures such as futures, options, forwards and swaps – rose 22% from the year before, while the use of exchange rate derivatives rose 19.8%. Although not the largest, but the fastest growing segment of the market was credit derivatives whose use grew by 134% since the end of 2003 to reach a total of $2.347 trillion at year's end.

Banks' use of forwards and futures contracts showed little growth over the past two years. Outstanding amounts were $11.37 trillion at the end of 2002, rose slightly to $11.39 at the end of 2003 and then dropped back a bit to $11.37 at the end of 2004.

The credit losses charged off by banks due to the failure of their derivatives counterparties to fully perform on their derivatives contracts rose to $257 million in 2004, up from $94.7 million in 2003. Both of these figure are substantially below the $395.4 million in losses incurred back in 2001.

Credit exposure at the major derivatives dealing banks showed a decline from 2003, largely attributable to J.P.Morgan reporting a decline in their exposure from 845% to 593% of risk based capital. This large decrease offset increases at Citibank, Bank of America and HSBC. On average, the top five dealers had credit exposures from derivatives that exceeded 300% of their risk based capital.

Profits from trading in derivatives and cash instruments fell by over $1.4 billion in 2004 to a total of $9.87 billion ("cash" refers to securities and foreign currency). Although trading in foreign exchange derivatives and cash instruments proved profitable, bank loss $886 million in interest rates products in the last half of 2004 to drag down their overall trading and dealing profits.

Miscellaneous notes on the data

- The reported benefit of netting OTC derivatives contracts between counterparties rose materially from 1996 to the beginning of 2003. This benefit represents a reduction in derivatives dealers' credit exposure to other dealers and their customers. However the rise in this benefit appears to have leveled off over the past two years at between 81% to 84% of exposure due to netting.
- The OCC's figures above for overall amounts of outstanding derivatives do not include spot foreign exchange transactions and in some instances also do not include credit derivatives.

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