

## Banking by Anthony K. Wikrent

### Ten trillion dollars, and counting

*New estimates of the swaps and derivatives markets are coming in at almost double previous ones.*

**T**wo recently released studies, on the size of the swaps market and on how deeply involved the major U.S. commercial banks are in the financial derivatives markets, indicate that the derivatives markets are even larger than previously believed.

On Nov. 16, the London *Financial Times* reported that a New York City publication named *Swaps Monitor* had conducted a survey of the swaps market, and concluded that the notional principal amount of swaps outstanding is more than \$7 trillion, not \$4.5 trillion, as reported by the International Swap Dealers Association (ISDA).

The Comptroller of the Currency now estimates the exposure of the 10 largest U.S. banks at nearly \$10 trillion.

Swaps are financial transactions in which two "counterparties" agree to exchange two different financial obligations or financial assets that are based on two like-sized but differently denominated and/or differently capitalized principal amounts. For example, company A might give a stream of floating-rate interest payments to company B, receiving in exchange a stream of fixed-rate interest payments from a debtor of B. Or, A might give payments denominated in German marks to B, in return getting payments in U.S. dollars from a debtor of B.

The major commercial banks that arrange these swaps between A and B are the "swap dealers." These transactions are some of the "off-balance-sheet liabilities" that large commercial banks have rushed into since the market meltdown of October 1987,

and even before. They are "off-balance-sheet" because they are not loans, and therefore are not carried on the banks' balance sheets as assets.

These transactions are "liabilities" because the swap dealers usually don't find two counterparties to a swap. What the dealers (read, banks) usually do is pocket the up-front fee for writing the swap, assume the obligation of the second counterparty, and "inventory" the swap; that is, maintain the obligation until a second counterparty is found. In the June 15 *Wall Street Journal*, Martin Mayer revealed that the dealers/banks have been paying "incentives" to financially pressed companies to become the second counterparty in many swaps.

*Swaps Monitor* took the \$4.5 trillion ISDA figure as a base, and added the swaps done by non-ISDA members. The new figures come to \$6 trillion of interest rate swaps, and \$1.1 trillion of currency swaps.

According to the *Swaps Monitor* survey, the largest swaps dealer in the world is J.P. Morgan, with over \$450 billion in swaps outstanding, followed by Paribas and Chemical Bank. Of the top ten dealers, seven are U.S.-based, and three are French. The largest British dealer is Barclays, which was number eight in the interest rate swap market, with \$247 billion.

In fact, the *Swaps Monitor* data is probably understated. In hearings before the House Banking Committee, chaired by Rep. Henry B. Gonzalez (D-Tex.), on Oct. 28, the Office of the Comptroller of the Currency (OCC) released figures showing that Morgan had \$592.063 billion of

swaps outstanding as of June 30, 1993. Morgan's total portfolio of all derivatives (financial futures contracts, options, warrants, and other sundry instruments, in addition to swaps) had grown from \$1.014 trillion on June 30, 1992, to \$1.537 trillion on June 30, 1993. That is an increase of 51.6% in just one year.

According to OCC data, Morgan's derivatives were only the fourth largest of U.S. commercial banks. Chemical's was the largest, \$2.114 trillion, up 63.1% from a year ago. Bankers Trust was second, with \$1.802 trillion, nearly double the \$958 billion of a year ago. In third place was Citibank, whose derivatives had grown 25.5% in a year, to \$1.789 trillion. Following Morgan, were Chase Manhattan, with \$1.026 trillion; Bank of America, with \$894 billion; First National of Chicago, with \$457 billion, and Continental Bank, with \$170 billion.

Altogether, the derivatives activities of the eight largest U.S. commercial banks have grown 42.9% in a year, to \$9.788 trillion.

The banks argue that the notional principal amount is misleading, because only the payment streams are subject to risk, not the underlying principal. The OCC figured what the banks' "worst-case total credit equivalent exposure" (Wctcee) was from their derivatives activities, which was about 1.5% of the notional principal amount. But even these numbers overwhelm banks' balance sheets. Chemical's exposure of \$31.9 billion, for example, is 268% of its total capital. Bankers Trust has an exposure of \$29.5 billion, 571% of its capital base. Citibank's exposure of \$38.2 billion is 230% of its capital; Morgan's exposure of \$37.9 billion is 458% of its capital; and Chase's exposure of \$23.0 billion is 269% of its capital.