Derivatives: A Mixed Bag For U.S. Banks

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The good news for banks: Derivatives are booming. The bad news: Derivatives are back in the hot seat.

The big banks' aggressive marketing and use of derivatives is again under scrutiny, following the near-collapse of **Long-Term Capital Management** LP. Executives at several major banks have privately acknowledged that they traded with Long-Term Capital without a full overview of its risky strategies. In their eagerness to do business with the highflying hedge fund, many banks also were willing to cut corners on fees and margin calls.

That approach led to emergency meetings of high-level bankers last week to arrange a $3.5 billion rescue for the hedge fund. But it has also helped banks rack up record profits.

Companies such as **J.P. Morgan** & Co. and **Chase Manhattan** Corp. have been aggressively selling products designed to hedge risk throughout the long bull market. In the search for new clients, they have spread the use of derivatives from major international corporations to smaller companies, some of lower investment grade, not to mention such risky but profitable customers as hedge funds.

Derivatives, which are investments

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whose value is derived from underlying securities or some other asset, have become "a very important driver of earnings, an area of growth that's out of its infancy stage," says Judah Kraushaar, a bank analyst at Merrill Lynch & Co. "When you think about the risks that have grown up in the U.S. economy and abroad, the development of this product and the fact that banks have been pivotal in their development show how the banks have developed closer ties to their customers."

Sharp Increase

As a result, nearly four years after a series of derivatives-related blow-ups cost banks hundreds of millions of dollars—and hit **Bankers Trust** Corp. especially hard—the business of derivatives is bigger than ever. Analysts say this year's volatile markets have only added fuel to the fire.

The total face amount of all derivatives sold by commercial banks jumped 21% to a record in the second quarter from a year earlier: to $28.2 trillion, according to the Office of the Comptroller of the Currency. That is four times the size of the market at the end of 1991. The figures for the second quarter, the most recent for which data are available, don't include Wall Street investment banks, which needn't report their sales.

For commercial banks, total trading revenue for cash and off-balance-sheet positions set a record of $2.7 billion in the first quarter before falling slightly to $2.6 billion in the second quarter.

To be sure, the majority of these derivatives are fairly conservative, "plain-vanilla" instruments such as interest-rate swaps. But amid the fallout over Long-Term Capital, as well as the ongoing market volatility, analysts and regulators are asking how closely the banks are watching their risks in this frenetic environment.

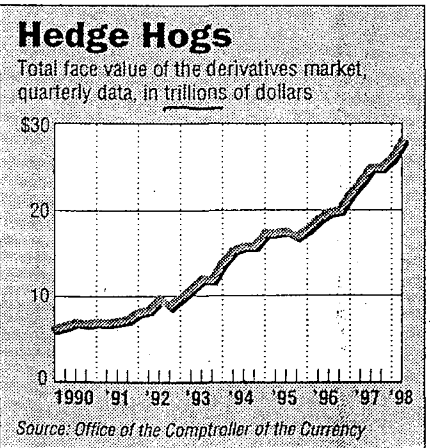
"Risk management across the system has generally improved, but derivatives have always been a major exception," says Edward Furash, a Washington, D.C., bank consultant. "No one really understands derivatives, and no one understands how to test the shock effects." During the long economic boom, he adds, "Banks have been engaged in risk warfare. In order to get wider spreads [between instruments] they're taking more risk for the same spreads. Bank portfolios for three to four years have been getting riskier."

Warnings From Fed

Indeed, Long-Term Capital was just the latest warning sign for banks. Bank charge-offs related to derivatives totaled $230 million in the first half of the year, compared with less than $3 million for banks in the first half of 1997, according to the OCC. Although that took only a small bite out of bank profits, it was enough to prod the Federal Reserve to issue warnings to bank supervisors about banks' risk systems and exposures—even before the banks banded together to prop up Long-Term Capital.

Many of the losses in the first half of the year were spurred by last fall's financial collapse in Asia, which cost some financial institutions a bundle. Among the Asian victims was J.P. Morgan, the leading derivatives dealer among banks, which still is embroiled in litigation with a South Korean securities firm, **SK Securities** Co., over $300 million in derivatives debts that Morgan says it is due.

While banks have ridden out most of



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those losses, problems are mounting. Last month, Russia delivered a nasty blow to financial institutions that had tried to hedge risks in their ruble-denominated bonds. Many of those institutions had purchased futures contracts with Russian banks that would insulate them from a deterioration in the ruble. But Russia coupled a devaluation with a debt-repayment moratorium that wiped out many of those contracts—a stunning and unprecedented blow that has fueled investors' fears around the globe. That set off a flight from stocks and bonds of all kinds across the globe.

Concern Over Vulnerability

While most damage has been limited to financial institutions, some analysts worry that a greater number of corporations also are now vulnerable to derivatives risks, given how widespread their use has become.

Four years ago, such well-known companies as **Procter & Gamble** Co. and **Gibson Greetings** Inc. took big hits after finding themselves on the wrong side of derivatives contracts when interest rates rose. Amid the globalization of corporations through the decade, the use of derivatives has spread to many more firms.

"The guy working out of his garage to sell computers now can sell them all around the world fairly quickly," says Robert P. Sullivan, lead partner in financial-risk management at PricewaterhouseCoopers LLP. Meanwhile, banks "are becoming more efficient in terms of being able to deal with smaller institutions," he adds.

Mike Brosnan, the OCC's deputy comptroller for risk evaluation, notes that banks have even started selling derivatives to some clients who are below investment-grade ratings—a small but growing concern for regulators.

"As business is maturing, banks are expanding the client base to increasingly typical customers—small businesses or companies that are rated triple-B or double-B," he says. "We're watching the target market expand, and it's getting bigger, and obviously if you're doing business with someone who's triple-B as opposed to double-A, they're more likely to get into trouble as their particular circumstances deteriorate."

Banks have even been inventing new types of derivatives. The hottest derivatives product is a recent innovation called credit derivatives, a contract designed to hedge loans or other assets against some credit risk itself. J.P. Morgan already has carved out a niche as the most aggressive seller of credit derivatives, which have surged in popularity over the past 18 months.

Of course, that was in a bull market. (!) Nancy Wentzler, director of economic analysis at the OCC, notes that credit derivatives "have not been fully tested in a period of economic distress." Raising what she calls a "flag of caution," she says credit derivatives need to be monitored as closely as traditional loans.

"New risk models don't substitute for good judgment," Ms. Wentzler says.