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Poster Presentation 10

DETERMINANTS OF DERIVATIVE USE BY COMMERCIAL BANKS

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Banks use of financial derivatives has been growing rapidly in recent years due to regulatory changes concerning the amount of capital banks are required to hold as well as an increase in their market risk exposure. Derivatives, namely, futures, options and swaps, are off-balance sheet instruments that allow banks to transform the duration of their balance sheets in order to manage market risk without incurring additional capital requirements. However, it has been argued that federal deposit insurance held by banks provides an incentive for banks to speculate with derivatives in an attempt to increase the value of shareholder equity by expanding into activities that shift risk onto the deposit insurer. Speculating with derivatives involves gambling on the future performance of the assets underlying the derivatives in an attempt to reap trading profits. However, using derivatives in such a manner subjects banks to higher rather than lower risk exposure and can lead to significant financial losses. Therefore, it is important from a regulatory perspective to determine how banks are using derivatives. This paper argues that banks engage in derivative activities to reduce their exposure to interest rate risk rather than to increase risk exposure by speculating.