anks using more credit swaps to diversify loans

AMSTERDAM, March 17 (Reuters) - Bank balance sheets are no longer what they used to be.

Major commercial banks around the world are increasingly using financial contracts known as credit swaps to diversify their loan portfolios, bankers said on Friday.

From a meagre $50 billion in 1996, credit swaps have grown into a $450 billion market, according to an estimate by the British Bankers' Association (BBA). Dealers estimate the market grew by about 30 percent in 1999.

By using credit derivatives, banks can increase or cut their exposure to a country or a corporation without actually making or selling the bank loan or bond. The contracts involve receiving or selling cash flow streams linked to an underlying loan or bond in return for a fee.

Banca Commerciale Italiana <BCMI.MI> (BCI), for instance, recently gained exposure to Australian companies without opening a branch office in that country. It bought credit derivatives receiving a stream of cash flows tied to Australian loan rates.

"Sometimes it is not possible or it is too difficult to set up business in every country," said Francesco Caputo Nassetti, head of capital markets in the international division of BCI.

The use of credit swaps, combined with bank loans, has allowed BCI to build a $15 billion credit exposure in its New York branch, larger than the bank's balance sheet for the U.S., Nassetti told reporters on the sidelines of the International Swaps and Derivatives Association (ISDA) annual conference.

Dennis Oakley, managing director at Chase Manhattan Bank <CMB.N>, said the bank made the decision to diversify its loan portfolio with credit derivatives about a year ago.

"We studied it and we decided liquidity is growing in the market and it's a good way to distribute our risk," he said.

A year later, "we have significant hedges on a significant portion of our balance sheet", Oakley said.

Amy Lai, director of global credit derivatives at Deutsche Bank AG <DBKGn.DE> and a dealer in credit swaps, said banks, insurance companies and other financial institutions were increasingly using derivatives such as default swaps and total-return swaps to gain or cut risk exposures. "It's a very efficient way to do it," she said.

GROWTH OF SWAP MARKET CHANGING NATURE OF BANKING

The growing use of swaps is changing the nature of traditional "relationship" commercial banking, bankers said at a panel discussion. Banks can have risks larger or less than the size of their balance sheets and buy and sell credit exposure far more easily with derivatives.

An ongoing criticism of the use of swaps and other synthetic financial instruments has been that bankers are bypassing client relationships and treating loans as commodities.

Bankers said both types of banking would co-exist. "As a foreign bank in the U.S., there are only so many customers we can develop into core relationships," said Nassetti at BCI. The bank's core U.S. customers tend to be companies with large businesses in Italy or Latin America, he said.

The growth of credit derivatives has been facilitated by the fact that regulators in many countries have given near-equal treatment to portfolio diversification with swaps as with loans or other instruments in calculating capital reserve ratios. A portfolio of diverse loans generally requires less capital reserves than a concentrated loan portfolio.

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