Derivatives pose “potentially lethal” threat to financial system

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11 March 2003

Warnings by America’s second richest man, Warren Buffett, the head of the investment company Berkshire Hathaway, of the potential dangers of financial derivatives to the global banking and financial system appear to have received speedy confirmation.

The *Financial Times* reported on Monday that the credit rating agency Fitch had found in a new survey that “European regional banks have taken on a lot more risk than their public accounts show because of heavy exposure to credit derivatives.” Fitch said the banks, more than half of which were German, had increased their exposure to high-yielding derivatives to offset falling profits in their traditional areas of business lending.

In his annual letter to shareholders last week, Buffett, who at the height of the share boom warned that the hi-tech market, measured by the Nasdaq index, was grossly overvalued, said that derivatives were “time bombs, both for the parties that deal in them and the economic system.” Posing a “mega-catastrophe risk,” derivatives were “financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.”

Derivatives, as the name implies, are financial contracts which call for money to change hands at some point in the future, with the amount to be determined by reference to other items, such as share prices, currency rates, or interest rates.

Originating in the need of businesses to hedge against risks associated with fluctuations in markets, or changes in financial conditions, the use of derivatives accelerated rapidly in the wake of the collapse of the Bretton Woods monetary system in 1973 as currencies were floated and financial markets were increasingly deregulated.

In the recent period, however, their growth has become truly explosive. According to one estimate “the market for custom-made derivatives—those specially designed to the specifications of companies or individuals—is estimated to be about $120,000 billion and has been growing by more than 10 percent every six months” [*Financial Times*, March 10, 2003].

In his newsletter, Buffett pointed out that before derivatives contracts were settled the parties to them had to record profits and losses in their earnings statements without any money actually changing hands.

This involves making an estimate of the value of the contract. Often the contracts are so complex that there is no specific market in them on which to base such an estimate. In that case a financial model has to be employed and this can lead to a wild overstatement of earnings.

According to Buffett, even honest errors will tend to be on the upside because of “the tendency to take an optimistic view of one’s commitments.” However, parties to derivatives also have an “enormous incentive to cheat in accounting for them” under conditions were the earnings of the derivatives traders are calculated according to the profits they return. Therefore it was possible to have a situation where two parties to a contract, using different models, could both show substantial profits on the same contract.

Buffett pointed out that the valuation problem was far from academic with huge-scale frauds and near-frauds being facilitated by derivatives trades in recent years. “In the energy and electric utility sectors, for example, companies used derivatives and trading activities to report great ‘earnings’—until the roof fell in when they actually tried to convert the derivatives-related receivables on their balance sheets into cash.”

The errors in the derivatives market, he continued, have not been symmetrical. “Almost invariably, they have favoured either the trader who was eyeing a multimillion dollar bonus or the CEO who wanted to report impressive ‘earnings’ (or both).”

Buffett acknowledged that the argument that derivatives, by transferring risks, helped to bring stability,

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facilitate trade and eliminate bumps was often true at the micro level. But the macro picture "is dangerous and getting more so."

"Large amounts of risk, particularly credit risk have become concentrated in the hands of relatively few derivatives dealers, who in addition trade extensively with one another. The troubles of one could quickly infect the others. On top of that, these dealers are owed huge amounts by nondealer counterparties."

His report pointed to what he called "daisy-chain risk," akin to that risk run by insurers and reinsurers that lay off much of their business to others. The existence of such linkages could cause companies that were quite sound to go under. This type of "linkage" problem was one of the reasons for the creation of the Federal Reserve System in 1913. Before its establishment, the collapse of weak banks could threaten the strong ones. Now the Fed can move in to insulate the strong from the problems of the weak.

"But there is no central bank assigned the job of preventing the dominoes in insurance or derivatives," he warned. "In these industries, firms that are fundamentally solid can become troubled simply because of the travails of other firms further down the chain."

This type of threat was clearly in evidence in the collapse of derivatives trader Long Term Capital Management (LTCM) in September 1998 with some $1,400 billion worth of contracts on its books. Fearing that the whole US and global financial system might breakdown if LTCM went under, the US Federal Reserve Board stepped in to organise a $3 billion bailout.

While the LTCM rescue operation prevented a financial meltdown, Buffett's warnings point to the fact that in the four and a half years since then none of the underlying risks have lessened and may have worsened considerably.

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