Dangerous derivatives at the heart of the financial crisis

Financiers have engineered a "shadow banking system" that has subverted regulation and dumped risk. Complex derivative trades have fuelled a decade or more of cheap credit and destabilised the financial system. The financial and human costs are now being revealed as the massive borrowing spree unwinds, leaving the public purse to pay for failed corporate structures and the threat of a major economic recession.

Fund managers, insurers and bankers have transformed investment practices by creating financial instruments known as *derivatives*, whose value is derived from the price of another underlying asset. The original idea of derivatives was to help actors in the real economy, such as farmers and manufacturers, insure against risk. A company may want, for example, to guard against increases in the prices of steel, wheat or other commodities. Price stabilisation and risk mitigation are worthwhile objectives, but many derivatives trades have crossed the line into speculation rather than risk management. Companies have been encouraged in this by derivative traders, who make money each time they create or sell a new product.

Most derivatives are sold "over the counter" through private trades rather than on public stock or commodity exchanges. This gives investment banks flexibility to propose to their customers whatever deal they want, rather than being bound by the trades sanctioned by exchange supervisors. As the deals are secret they do not help other investors price risk, and often investors, regulators and other analysts do not know what liabilities a company has taken on.

There are several types of derivative, including futures, forwards, swaps and options. In the last twenty years traders have invented a series of ever more complicated deals that they have sold to manufacturers, but primarily to investors. An example is a paper company hedging on interest rates through a deal whereby it would receive a fixed rate of 5.5 per cent and pay a floating rate, squared and then divided by 6 percent.[1] One type of derivate instrument is a credit default swap. In these deals, which were valued at $62 trillion in December 2007[2], the buyer pays periodic payments to the seller in exchange for the right to a payoff if there is a default or credit write-down in respect of a mortgage or other debt securities they hold. The uncertainties about this huge market are a major factor in the 2007-2008 credit crunch, resulting in serious difficulties for many families and small businesses.

Derivatives traders have also developed collateralised debt obligations (CDOs) through which a financial institution combines assets of various types (for example "prime" mortgages with "subprime" ones). The packaged debt is then sold to a special purpose vehicle, generally registered offshore in a low tax jurisdiction. The new entity then issues its own equity or bonds to resell the debt to other investors, carving it up into different tranches with different risk ratings using complex mathematical models. The most actively traded CDOs are those made up of credit default swaps. CDOs are also themselves being repackaged into other CDOs, further obscuring the actual risk and ownership of the underlining assets. The interlinked complexity of these deals feeds volatility rather than reduces it.

Running rings round regulators

Financial innovation in the derivatives market has largely aimed to disguise risk, avoid regulations and generate higher short-term profits. Hedge funds, private equity corporations, investment banks and pension funds have used derivatives to evade regulations. They have devised elaborate and opaque financial vehicles through which they have dumped risks onto the state or onto less informed investors including pension holders. Many companies, including Enron and Parmalat, showed that this strategy works only in the short-term, but may prove disastrous after that. "Parmalat abused the capital markets for years by raising money under false pretences. Money was siphoned off for family purposes and the whole mess hidden in a complex structure of 200-plus subsidiaries and special purpose vehicles scattered across the globe, including tax havens such as the Cayman Islands, the Dutch Antilles and Cyprus."[3]

Billions of dollars have been placed off the balance sheets of corporations and financial institutions through securitisation, in which a special purpose company obtains the right to an income stream - such as from mortgage or export credit debt repayments or of sales of gas through a pipeline. AIG's financial services division and insurers found ways to circumvent rules under the 2004 Basel II agreement which required companies to put up more capital against risks. These and other insurers transferred risks to the capital markets through securitisation, lowering their own potential liabilities and thus the amount of capital they were required to hold against losses. This strategy failed dramatically for AIG in September 2008.

Governments have also used securitisation to get round rules they have agreed to. European countries adopting the Euro as their currency agreed that annual government borrowing should remain below 3 per cent of GDP and that the ratio of government debt to GDP does not exceed 60 per cent. EU governments have turned to derivatives and securitisation as a means of removing debt from the public accounts and of raising capital without increasing their official debt burden. Pension payments for former state employees, Export Credit Agency debts, and government real estate have all been put out to the market. In Germany, for example, the government securitised post office and telecom workers' pensions, raising $7 billion against the future income from the workers' pension pot. Italy's SACE export credit agency has securitised $1.17 billion of debt owed by countries in Africa, the Carribean, the Middle East, Asia, Eastern Europe and Latin America. Britain's Export Credit Guarantee Department, France's COFACE, Germany's Hermes and the USA's ExIm bank are trying to follow this example.[4]

Nicholas Hildyard of UK-based research institution, the Cornerhouse, comments "for campaigners working to cancel illegitimate third world debt, securitisation of ECA debt is of considerable concern."[5] The claims that are transferred through securitisation are often disposed of without informing or obtaining agreement from the debtor country. Once ownership of the debt is dispersed it becomes difficult for the originating government to restructure or cancel claims, as Argentina found earlier this decade.

Hildyard also comments that "many strategies such as shareholder resolutions or corporate social responsibility policies developed by human rights and environmental activists to influence corporate decision-making have now been made irrelevant." Many corporate deals are not subject to the minimum oversight that institutional shareholders provide for companies that are traded on stock exchanges. As derivatives are traded over the counter, regulators and citizens are kept in the dark.

"Financial concerns, and those who voice them, are ever more influential in setting corporate strategies", as the International Trade Union Confederation states.[6] Satisfying the "speculative economy" has reshaped corporate and government behaviour. Securitisation and derivative-based swaps have enabled the consolidation of corporate power through a wave of mergers and acquisitions in industries such as iron, agrochemicals, soya bean processing, pharmaceuticals and banking. Hedge funds and private equity companies, operating with massive leverage, have increased corporate control over health care, water and energy. The impacts on employees, pensioners, householders, the sick and others who stand in the way of profit – have been profound.

What is to be done?

The collapse of confidence in the financial sector is dragging down the real economy, leading to what is likely to be a severe recession. To obtain greater stability, and equity, the public must reassert control and promote a banking system that acts within clear limits and in favour of the many, rather than the few. The emergency nationalisations of failing banks should open space to push for new forms of ownership and control over the provision and management of credit.

Derivatives, the key mechanism in the shadow banking system created in recent years, must be strongly regulated. At present most discussions emphasise transparency reforms such as ensuring that any derivatives or similar trades are only done via exchanges. This will not suffice. Cambridge University economist John Eatwell and investment manager Robert Reoch comment: "The problem is not a lack of transparency of such instruments but their complexity and the lack of controls employed by buyers and sellers." Herding instincts among financiers and ratings agencies mean that "no amount of extra transparency will result in greater stability."[7] Former derivatives broker turned law professor Frank Partnoy recommends treating derivatives like other financial instruments, increasing prosecutions of financial frauds, improving disclosure by moving from a rules-based to a standards-based reporting framework, and ensuring that regulations do not confer oligopoly power on gatekeepers such as ratings agencies or auditors.[8]

Reforms will only be significant if citizens inform themselves and mobilise on these issues to overcome the pressures of special interest lobbies such as the powerful International Swaps and Derivatives Association. Much of the money used by derivatives traders comes from institutions such as pension funds, university endowments, and municipal funds – which are vulnerable to public pressure. With these entry points, plus the unprecedented public and political debate on the problems with globalised, liberalised finance, the banking system may be dragged back out from the shadows.

- by Alex Wilks, Eurodad.

This short brief draws heavily on *A (Crumbling) Wall of Money, Financial Bricolage*, Derivatives and Power by Nicholas Hildyard, available on the Corner House website www.thecornerhouse.org.uk/summary.shtml?x=562658. Thanks to Peter Chowla for comments.

For endnotes, please find this article online at: http://www.eurodad.org

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