A $516 trillion derivatives 'time-bomb'

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> The market is worth more than $516 trillion, (£303 trillion), roughly 10 times the value of the entire world's output: it's been called the "ticking time-bomb". It's a market in which the lead protagonists – typically aggressive, highly educated, and now wealthy young men – have flourished in the derivatives boom. But it's a market that is set to come to a crashing halt – the Great Unwind has begun.

Last week the beginning of the end started for many hedge funds with the combination of diving market values and worried investors pulling out their cash for safer climes.

Some of the world's biggest hedge funds – SAC Capital, Lone Pine and Tiger Global – all revealed they were sitting on double-digit losses this year. September's falls wiped out any profits made in the rest of the year. Polygon, once a darling of the London hedge fund circuit, last week said it was capping the basic salaries of its managers to £100,000 each. Not bad for the average punter but some way off the tens of millions plundered by these hotshots during the good times. But few will be shedding any tears.

The complex and opaque derivatives markets in which these hedge funds played has been dubbed the world's biggest black hole because they operate outside of the grasp of governments, tax inspectors and regulators. They operate in a parallel, shadow world to the rest of the banking system. They are private contracts between two companies or institutions which can't be controlled or properly assessed. In themselves derivative contracts are not dangerous, but if one of them should go wrong – the bad 2 per cent as it's been called – then it is the domino effect which could be so enormous and scary.

Most markets have something behind them. Central banks require reserves – something that backs up the transaction. But derivatives don't have anything – because they are not real money, but paper money. It is also impossible to establish their worth – the $516 trillion number is actually only a notional one. In the mid-Nineties, Nick Leeson lost Barings £1.3bn trading in derivatives, and the bank went bust. In 1998 hedge fund LTCM's $5bn loss nearly brought down the entire system. In fragile times like this, another LTCM could have catastrophic results.

That is why everyone is now so frightened, even the traders, who are desperately trying to unwind their positions but finding it impossible because trading is so volatile and it's difficult to find counterparties. Nor have the hedge funds been in the slightest bit interested in succumbing to normal rules: of the world's thousands of hedge funds only 24 have volunteered to sign up to a code of conduct.

Few understand how this world operates. The US Federal Reserve chairman, Ben Bernanke, tapped up some of Wall Street's best for a primer on their workings when he took the job a few years ago. Britain's financial regulator, the Financial Services Authority, has long talked about the problems the markets could face on the back of derivative complexity. Unfortunately it did little to curb the products' growth.

In America the naysayers have been rather more vocal for longer. Famously, Warren Buffett, the billionaire who made his money the old-fashioned way, called them "weapons of mass destruction". In the late 1990s when confidence was roaring in the midst of the dotcom boom, a small band of politicians, uncomfortable with the ease with which banks would be allowed to play in these burgeoning markets, were painted as Luddites failing to move with the times.

Little-known Democratic senator Byron Dorgan from North Dakota was one of the most vociferous refuseniks, telling his supposedly more savvy New York peers of the dangers. "If you want to gamble, go to Las Vegas. If you want to trade in derivatives, God bless you," he said. He was ignored.

What is a Derivative?

Warren Buffett, the American investment guru, dubbed them "financial weapons of mass destruction", but for the once-great-and-good of Wall Street they were the currency that enabled banks, hedge funds and other speculators to make billions.

Anything that carries a price can spawn a derivatives market. They are financial contracts sold to pass on risk to others. The credit or bond derivatives market is one such example. It is thought that speculation in this area alone is worth more than $56 trillion (£33 trillion), although that probably underestimates the true figure since lax regulation has seen the market explode over the past two years.

At the core of this market is the credit derivative swap, effectively an insurance policy against the default in the interest payment on a corporate bond. One doesn't even need to own the bond itself. It is like Joe Public buying an insurance policy on someone else's house and pocketing the full value if it burns down.

As markets slid into crisis, and banks and corporations began to default on bond payments, many of these policies have proved worthless.

Emilio Botin, the chairman of Santander, the Spanish bank that has enjoyed phenomenal success during the credit crunch, once said: "I never invest in something I don't understand." A wise man, you may think.

http://www.independent.co.uk/news/business/news/a-163516-trillion-derivatives-timebomb-958699.html

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