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# Derivatives – A Potential Financial Tsunami?

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> Derivatives generate reported earnings that are often wildly overstated and based on estimates whose inaccuracy may not be exposed for many years. -Warren Buffet

Derivatives are complex financial transactions based upon underlying instruments like real estate, bonds or stocks and are of two main types; either bets about the direction of some market, or insurance, that takes on a hedging function against a market position.

The total amount of derivatives is now estimated (2006 mid-year market survey), by the International Swaps and Derivatives Association (ISDA), to be over $283 trillion. That number is about 7 times the economic output of the entire world, at about $40 trillion.

The ISDA, which represents participants in the privately negotiated derivatives industry, is among the world's largest global financial trade associations as measured by number of member firms. ISDA was chartered in 1985, and today has approximately 780 member institutions from 54 countries on six continents.

These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

Here is data from that report:

> Notional amount outstanding of interest rate swaps and options and cross-currency swaps grew by 18 percent to $250.8 trillion from $213.2 trillion. The annual growth rate for interest rate derivatives to mid-2006 is 25 percent from $201.4 trillion in mid-2005. 101 primary member firms provided interest rate derivatives data.
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> Notional amount of credit default swaps grew by 52% in the first six months of the year to $26.0 trillion from $17.1 trillion. The annual growth rate for credit derivatives is 109% from $12.4 trillion at mid-year 2005. 88 firms provided credit default swap data.
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> Finally, notional amount outstanding of equity derivatives, which consist of equity swaps, options, and forwards, grew by 15 percent from $5.5 trillion to $6.4 trillion. This represents year-on-year growth of 32 percent from $4.8 trillion at mid-year 2005. 87 firms provided equity derivatives data.

And this does not refer to exchange derivatives, like futures contracts which are small by comparison. What it does refer to are the unregulated derivatives contracts between hedge funds, pension funds, banks, insurance companies, etc.

Interestingly, Mr. Buffett had previously stated banks simply have no idea what their exposure could be. “When Charlie [Munger, his business partner] and I finish reading the long footnotes detailing the derivatives activities of major banks, the only thing we understand is that we don’t understand how much risk the institution is taking.”

Also, the $6 billion loss in natural gas by the Amaranth hedge fund demonstrates how even experienced traders can suddenly and unexpectedly undergo a tremendous loss. This begs the question that if the financial system were to experience a major shock how would that possibly be covered?

Mr. Buffett has said that such highly complex financial instruments are time bombs and “financial weapons of mass destruction” that could harm not only their buyers and sellers, but the whole economic system.

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