The Problem with Derivatives

By Logan Lengacher

"Those who cannot remember the past are condemned to repeat it." The famous quote from George Santayana has been ingrained in our brains because it has been used to describe nearly every catastrophe since the beginning of recorded history. However cliché the quote is, it perfectly describes what the United States economy is facing with the growing derivatives market. This is the same derivative market that caused the housing market crash less than a decade ago that plunged us into the Great Recession. Now we must ask ourselves a couple of questions. How did we forget what caused the Great Recession so quickly, and how do we stop ourselves from falling into another Great Recession?

To answer the question of how we forgot the cause of the Great Recession so quickly, we have to look at the Great Recession itself. Ask anyone on the street and they will tell you that the cause of the Great Recession was the bursting of the United States hosing bubble, which is correct. But what caused this housing bubble to form? The answer is the unregulated derivatives market. Since the late 1990s, the United States housing market was growing at an incredible rate. Financial institutions wanted to cash in on this growing market, so they created CMOs or collateralized mortgage obligations. CMOs are a type of derivative where there is pool of owned mortgages that are owned by investors who receive cash flows from the mortgage payments. In the beginning, mortgages were only given to "prime" candidates. A prime candidate is considered to be the highest quality of borrower which means he is the most credit-worthy. These mortgages were safe because the borrowers had the ability to pay back the loan. These CMOs were considered safe and gave a high rate of return. Investors were hooked and wanted more and more CMOs. This was the beginning of the end for the United States housing bubble. As you can imagine, there were a limited number of prime borrowers, but investors had an unlimited appetite for CMOs. To satisfy this unlimited appetite for CMOs lenders began giving mortgages to sub-prime borrowers. Although these new CMOs were made up of risky mortgages, they were still considered safe investments. Money flowed into these risky CMOs and eventually the market crashed, causing derivatives associated with these mortgages to lose value too. This was the beginning of the Great Recession in the United States.

Some people may argue against the point that we are bound for another Great Recession because the housing market is not out of control. Some might say that we do not have to worry about another Great Recession because there is no housing bubble. What the general public is failing to realize is that the derivatives market it what caused the housing bubble to form in the first place. The problem with the derivatives market is that it is highly unregulated and massive. It allows investors to make bets on assets that they themselves have no connection to. Also, a conservative estimate of the size of the derivative market it $700 trillion, while the combined world GDP is only $70 trillion. This means that when a boom is occurring, for example the housing boom, money is not only flowing into the housing market directly but also indirectly with derivatives on the mortgages. The amount of money grows even greater when you add in synthetic derivatives which are bets that the asset will fail. Therefore, when the boom finally ends and the bust begins, more money can be lost than ever before imagined. What has been done to change the derivative market since 2008? The answer is nearly nothing. The same banks that were too big to fail in 2008 are even bigger and continue to deal in the derivatives market.

Since it appears that we are well on our way to another Great Recession, we need to answer one question. How do we prevent this? There is one very simple answer—greater regulation of the derivative market. Although the passage of the Dodd-Frank Act has improved the regulation of some derivatives, it has not gone far enough. Many over-the-counter derivatives are still unregulated today. However, some are still against greater regulation of the derivatives market. Many people who argue against more regulation of the financial industry say that greater regulation slows the growth of the economy. This may be true; however, I do not believe that this is necessarily a bad thing for the economy. Even with increased regulation, there would still be booms and busts in the economy, but increased regulation would make these booms and busts much less severe. This increased regulation would allow for more steady and sustainable growth. Also, increased regulation of the derivatives market would make it much more transparent. This means that investors would be able to more clearly see what exactly they are investing in. If these regulations would have been in place before 2008, I believe they would have prevented the Great Recession. Investors would have not poured money into collateralized mortgage obligations if they knew that these derivatives were built on loans that people could not pay back. Lack of regulation of the derivatives market has already caused one Great Recession. Hopefully there will be more regulations put on derivatives before we are too late to prevent another.