A Time We Would Like to Forget

By Kaelin Martlock

The Great Recession took place approximately seven years ago, and controversy still arises as to what caused this historical financial crisis. The derivative market is said to be responsible for a variety of financial disasters. Derivatives are financial contracts that are derived from the behavior of something else, such as interest rates, mortgages, commodities, or weather. They are contracts that transfer risk from one investor to another investor. Many of these agreements are private contracts between banks or investors. Since most are private or over the counter, it is hard to determine the exact size of the derivative market. The minimum size of the derivative market is a massive 700 trillion dollars.

Not only is the derivative market hard to track, but it is also not regulated. This poses a danger to the entire financial system as a whole. One argument for the derivative market is that derivatives break up risk into different parts to split up losses. In reality, risk is not being reduced by derivatives. Instead of splitting the risk up, derivatives create their own type of risk.

Derivatives can be effective when trading costs are low and the risk is well spread out among the different investors. Market competition is what is important. Even though some investors may view derivatives as a positive aspect of the economy, I find many flaws in the system. Derivative contracts transfer wealth from one investor to another investor. However, this wealth is not directly added or subtracted from the total wealth of the economy. This can cause significant suffering for financial institutions. For example, a financial establishment might experience a large loss on a derivative or multiple derivatives. This may force the establishment to make some critical decisions in regards to bankruptcy costs and costs for the counterparties that were involved.

The derivative market played a large role in the recession that took place in the United States from 2007 to 2009. It is quite incredible to think about how differently our economy would operate if derivatives did not exist. The financial crisis was intensified when insurance companies used CDs to sell protection on CDOs that were backed by mortgages. When the CDOs experienced losses on the mortgage defaults, banks experienced hard times because they had relied on the protection of this credit swap. A number of banks had to be bailed out for different reasons, one reason being the potential outcomes of their derivative portfolios.

To put the effects of this financial crisis in perspective, the Federal Reserve had to lend 182 billion dollars to AIG so they would not go under. The story of the bailout of AIG is a perfect example of the costly aftermath of the Great Recession. When AIG was bailed out, Goldman Sachs, Morgan Stanley, Bank of America, Merrill Lynch, and many European banks were also saved from enormous losses. These financial establishments were involved in the derivative market along with AIG. AIG lost all its bets, which forced the company into a panic phase and caused great distress. AIG had many problems during this financial crisis, but the derivative market amplified all its problems.

The derivative market is very inconsistent because it has to do with systematic risk. This is risk that affects the entire market and is extremely unpredictable. In order to reduce systematic risk in the derivative market, derivatives need to become more regulated. Regulators should push for more extensive clearing criteria. They should also pressure dealers to set a numerical target for their contracts. This would give investors an idea of what they want to accomplish through their investment.

In order for derivatives to have a more positive impact on the economy, a better plan needs to be created in regards to over-the-counter prices of derivatives. Financial establishments should elect a group of individuals to keep track of their derivatives. These people should be professional risk auditors which would be responsible for the losses that the derivatives create. This may then put more pressure on the company to be more obedient when it comes to investments that have a great deal of systematic risk attached to them. A greater competition could be created among investors if the contracts were widespread over an electronic trading platform.

Since 2009, massive efforts have been made to clean up the banks, and regulations have been created in hopes of restoring trust and confidence in the financial system. If the derivative market continues to cause so many problems in our economy, another financial crisis is unavoidable. Banks today are bigger than ever. They continue to trade in derivatives and systematic risk just as they did before the Great Recession but on an even larger scale. The derivative market needs to become more regulated. Until then, we can only brace ourselves for the next financial downturn.