Derivatives: A $700+ Trillion Bubble Waiting to Burst

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In the past three years, while banks all over the world and Wall Street were imploding, while some $40-$50 trillion of capital was being destroyed in global stock markets, one financial market kept growing. That market is the financial derivatives market.

According to the Bank for International Settlements [BIS], the global Over the Counter [OTC] derivatives market has grown almost 65% from $414.8 trillion in December, 2006 to $683.7 trillion in June of 2008. On the BIS's own website, there are no updated figures for the notional derivatives market since June 2008, so we can likely assume, with some margin of safety, that this market has now grown to more than $700 trillion. Comparatively speaking, the total market cap of all major global stock markets is approximately $30 trillion.

Before I discuss how financial products could grow more than 65% during a time period when financial companies were imploding all over the world, let's review the definition of a derivative, because this will explain how this market of financial products keeps becoming more valuable at a time when the value of many capital assets are sinking like a rock in an ocean.

According to Wikipedia:

Derivatives are financial contracts, or financial instruments, whose values are derived from the value of something else (known as the underlying). The underlying value on which a derivative is based can be an asset (e.g., commodities, equities (stocks), residential mortgages, commercial real estate, loans, bonds), an index (e.g., interest rates, exchange rates, stock market indices, consumer price index [CPI] — see inflation derivatives), weather conditions, or other items. Credit derivatives are based on loans, bonds or other forms of credit. The main types of derivatives are forwards, futures, options, and swaps.

Because the value of a derivative is contingent on the value of the underlying, the notional value of derivatives is recorded off the balance sheet of an institution, although the market value of derivatives is recorded on the balance sheet. Over-the-counter [OTC] derivatives are contracts that are traded (and privately negotiated) directly between two parties, without going through an exchange or other intermediary. The OTC derivative market is the largest market for derivatives, and is largely unregulated with respect to disclosure of information between the parties, since the OTC market is made up of banks and other highly sophisticated parties, such as hedge funds… Because OTC derivatives are not traded on an exchange, there is no central counterparty. Therefore, they are subject to counterparty risk, like an ordinary contract, since each counterparty relies on the other to perform.

There are two key phrases to note in the above explanation of the financial derivatives markets-

(1)The notional value of derivatives is recorded **OFF** the balance sheet of an institution, although the market value of derivatives is recorded **ON** the balance sheet; and

(2)OTC derivatives are not traded on an exchange, there is no central counterparty. Therefore, they are subject to **counterparty risk**, like an ordinary contract, since each counterparty relies on the other to perform.

As I've noted before, the $700 trillion global derivatives market is the notional value of this market, not the market value of these derivatives. The Bank for International Settlements compiles the notional value of this market worldwide from reported figures by Central Banks of the G10

countries and Switzerland. Thus, if the off-balance sheet assets of major international banks are growing so rapidly in the form of their notional values of their held financial derivative products, how can so many of these banks be in trouble?

The answer, quite simply, is that the market value of these derivatives is nowhere near the notional values of these derivatives maintained and reported by these banks, and that the global derivatives market is in serious trouble. Because derivative products are subject to counterparty risks as well, this means that the failure of one major financial institution could cause the evaporation of assets for many other financial institutions that have derivative products with exposure to that one financial institution. In other words, when the notional values of a good percent of these financial derivative products start evaporating into thin air, and they will, it will have a negative domino effect on the balance sheet of not just one major financial institution, but many.

Of course, when FASB suspended mark-to-market accounting rules recently, major international banks were allowed to re-value some of their derivative products closer to their notional value on their books to pad their balance sheets. Due to this change in accounting law, I can almost guarantee you that before market open Friday, Citigroup will announce better than expected financial results as they carried huge amounts of illiquid mortgages and financial derivatives on their balance sheets. [*Editor's note: Article was written prior to earnings announcement on 4/17/09*]

Though many people argue that only the market value of these derivatives, and not their notional values, is ultimately important, this would have only been valid if FASB hadn't suspended mark-to-market accounting rules. The types of derivative products most likely to continue to blow up are Credit Default Swaps [CDS], and indeed, it wasAIG's exposure to Credit Default Swaps that caused it to collapse.

In reality, the market value of financial derivatives is only a fraction of its $700 trillion notional value; however the reality is that the potential losses from bad Credit Default Swaps can also be much more than their notional value. For example, consider a scenario where Company ABC underwrites a CDS in which they will receive $100,000 of payments from Company X in return for guaranteeing a $1,000,000 bond issued by Company Z. If all goes well, and the bond performs, then company ABC makes $100,000 in profit. However, if company Z fails, then Company ABC may now have to pay Company X $1,000,000. This is a scenario in which the losses from financial derivative products can be very real and very large. Though many analysts harp on the fact that the $700+ trillion notional figure of the derivative market is not real, it is not realistic either to only consider the much smaller market value of these derivatives as the above example illustrates.

Since it is now likely that the balance sheets of many financial institutions have been quickly "nursed back to health" by returning the book value of OTC financial derivative products to some fantasyland notional value versus their true market value, the collapse of the notional value of the $700+ trillion derivative market will indeed have future devastating consequences for global economies.

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