A buffetting for derivatives

Warren Buffett's outspoken condemnation of derivatives received wide press coverage in early March. Everyone recognises Buffett as a shrewd and experienced observer of the business world. David Rowe argues, however, that while his remarks contain some important hard truths, his extreme conclusions reflect the fact that a little knowledge is a dangerous thing

As has been widely publicised, Warren Buffett's latest letter to stockholders condemned derivatives as "financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal".[1] He claims these instruments introduce little-understood systemic risks that could allow a problem at one firm to snowball into a major economic crisis.

Buffett's strongest argument relates to situations where there is no real market for a contract and (although he doesn't make this point) no way to structure an effective hedge. He argues that this often leads to excessive use of mark-to-model valuation and this point must be taken seriously. As he emphasises, there need not be overt fraud for such evaluations to be seriously in error. The very complexity of the transactions can easily result in experts quite honestly holding widely varying opinions.

This argues that market-makers must exercise extreme caution when introducing new types of transactions for which there are no external price benchmarks, no effective hedge instruments and little two-way deal flow. As Buffett quite correctly points out, "marking errors in the derivatives business have not been symmetrical". Both traders and senior managers are anxious to show favourable performance. When new, illiquid and unhedgable transactions are valued using mark-to-model techniques, the seductive opportunities for serious inflation of earnings are all too real.

In this context, I personally believe that stricter accounting standards need to be applied to the use of mark-to-model methods. At a minimum, there should be disclosure of what fraction of a dealer's book is subject to mark-to-model methods and what are the gross positive and gross negative values derived by this approach.

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Alarmist

Buffett's most alarmist comments centre around credit risk. In fact, he often writes like a man who has just discovered that trading long-dated derivatives gives rise to credit risk and is deathly afraid that no-one else has yet recognised this fact. He says market-makers may see themselves as prudent, believing their credit exposure to be diversified and therefore not dangerous. Then he goes on to say: "Under certain circumstances an exogenous shock that causes receivables from Company A to go bad will also affect those from Companies B through Z." What is one to make of this purely hypothetical example? First, it applies to all types of credit exposures, not just those from trading derivatives. Recognising the dangers of excessive portfolio concentrations by industry or region is a well-known aspect of good credit risk management. Why should anyone be surprised that this is true for the credit risk dimension of derivatives trading?

Buffett also states that: "Large amounts of risk, particularly credit risk, have become concentrated in the hands of relatively few derivatives dealers, who in addition trade extensively with one another. The troubles of one could quickly infect the others." The sweep of this unsupported claim is breathtaking. If he is referring to credit derivatives, it is the net long or short exposure to various names that is at issue. If anything, credit derivatives have allowed credit exposure to be more widely distributed, and individual institutions to be more effectively diversified, than was true 10 years ago. If he is referring to counterparty credit exposure from bilateral trading positions, then this is nothing more than the long-recognised fact that this business gives rise to such exposures, that they are dynamic, and that they need to be measured and managed carefully. Sophisticated systems for doing this began to be deployed more than 10 years ago and have been steadily improved since.

Buffett also offers no empirical evidence for a high risk of contagion whereby the failure of one dealer "could quickly infect the others". This is simply offered as a blanket assertion. In fact, major dealers monitor their bilateral exposures in detail and generally collateralise them beyond some threshold amount. Moreover, any dealer's net open position is a tiny fraction of its gross long and short positions. If such a dealer were to fail, significant gross replacement contract demand would be generated but it would tend to be fairly balanced between demand for long and short positions.

Buffett also fails to mention one potentially favourable systemic dimension of derivatives credit risk. If most end-users are hedging and not speculating, as I believe to be the case, then there is favourable covariance between exposure and credit quality. If a business risk that has been partially hedged still results in a company's failure, the derivatives contract will be out-of-the-money to the dealer at the time of failure, resulting in no credit loss. While this phenomenon is far from universal, I believe it is a systemic factor that works to mitigate the risk of credit losses from derivatives trading.

Buffett correctly points out the dangers of mark-to-model accounting. Some accounting reform and certainly greater transparency should be sought in this area. Beyond that, however, Buffett makes blanket assertions of latent systemic risk while offering no empirical support. He also appears to be unaware of the sophisticated nature of the systems used by the largest dealers to monitor and control counterparty credit risk. If anything, his critique highlights the importance of such systems and the need to treat derivatives credit risk just as seriously as all other forms of credit risk. ■

The last of David Rowe's series of columns on Basel II and pro-cyclicality will appear in the May issue of *Risk*

[1] *See 'Avoiding a mega-catastrophe' at www.fortune.com/fortune/specials/2003/0317/buffett/buffett_home.html*