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To what extent, if at all, is it true to say that “ Derivatives are toxic weapons of financial mass destruction” Derivatives are an integral part of modern financial markets. Simply stated, a derivative instrument is a contract between two entities that specifies the values, dates, notional amounts and other conditions under which the transaction between them is to take place (usually at a future date). Derivates play an important role in streamlining economic activity, as well as to facilitate liquidity in the markets. Credit derivatives are an especially sought after instrument due to the legal exemptions afforded it. On the flip side, the inherent complexity and speculative element in derivatives make them a high-risk option. In the context of financial market booms and busts, derivatives are often criticized for artificially (yet inevitably) creating these cycles. For this reason, it is not unreasonable to claim that ‘ derivatives are toxic instruments of financial mass destruction’, although they have their utility when employed prudently.

The role played by derivatives during the 2001 dotcom bubble as well as the more recent 2008 crash of global equity markets is now beyond doubt. The sovereign debt crisis in Greece and Italy are notable examples of the dangers associated with derivatives. Yet, in an atmosphere of deregulation of financial markets, traders and merchants using this controversial financial instrument are given greater incentive to take risk. In other words, the present legal and regulatory climate encourages corporate greed and irresponsible risk-taking, which can only lead to economic crisis. As the case of the collapse of Lehman Brothers in 2008 clearly illustrates, the unrealistic ambition of CEOs of large corporations is facilitated by derivative instruments. For example, Henry Fuld, the Lehman Brothers CEO who took his company to bankruptcy, had earned $350 million as compensation in the three years before the collapse. This figure is comparable to the money earned by Henry Ford, the founder of the Ford Motor Company in the three years leading up to the Great Depression. The deregulated economic environment of the Coolidge years is quite similar to the right-wing economic policies implemented by the Bush Administration during its 8 year tenure. It seems remarkable that in spite of several episodes of recession in the last sixty years, the legislatures of advanced economies have not been suitably amended to mitigate future recessions and stock market collapses.

To be fair to derivatives, they can perform some useful economic functions. Due to augmented activities by derivative market participants, there could be substantial increase in savings and investments over the long term. But the severe decline in the state of world economy in the last two years gives cause for reassessing the need for derivatives. The bursting of the housing bubble in the United States alongside a precarious credit crunch situation have played major roles in precipitating the latest episode of economic recession in many countries. While the advanced nations in North America and Western Europe have borne the brunt of the recession, lesser developed economies and several emerging markets are simultaneously experiencing a slowdown in economic activity. Financial analysts and political commentators point out that the unregulated financial markets of Western democracies and the excessive use of derivatives make such crises inevitable. Hence, there is much merit to the argument that ‘ derivatives are toxic weapons of financial mass destruction’.

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