Derivatives and mark-to-market

Letters: 2002, 2008 · Difficulty: Advanced

Summary

Many **derivatives** have no market price, so their fair value is estimated with models. Buffett shows how traders and companies booked large "earnings" from optimistic estimates ("mark-to-myth") that later vanished, and calls derivatives "financial weapons of mass destruction."

2002 letter

I like this division of labor and hope to join with Leucadia in future transactions. On the minus side, the Finance line also includes the operations of General Re Securities, a derivatives and trading business. This entity lost $173 million pre-tax last year, a result that, in part, is a belated acknowledgment of faulty, albeit st andard, accounting it used in earlier periods. Derivatives, in fact, deserve an extensive look, both in respect to the accounting their users employ and to the problems they may pose for both individual companies and our economy.

Derivatives Charlie and I are of one mind in how we feel about derivatives and the trading activities that go with them: We view them as time bombs, both for the parties that deal in them and the economic system. Having delivered that thought, which I'll get back to, let me retreat to explaining derivatives, though the explanation must be general because the word covers an extraordinarily wide range of financial contracts. Essentially, these instruments call for money to change hands at some future date, with the amount to be determined by one or more reference items, such as inte rest rates, stock prices or currency values. If, for example, you are either long or short an S&P 500 futures contract, you are a party to a very simple derivatives transaction – with your gain or loss derived from movements in the index.

Derivatives contracts are of varying duration (running sometimes to 20 or more years) and their value is often tied to several variables. Unless derivatives contracts are collateralized or guaranteed, their ultimate value also depends on the creditworthiness of the counterparties to them. In th e meantime, though, before a contract is settled, the counterparties record profits and losses – often huge in amount – in their current earnings statements without so much as a penny changing hands. The range of derivatives contracts is limited only by the imagination of man (or sometimes, so it seems, madmen).

At Enron, for example, newsprint and broadband derivatives, due to be settled many years in the future, were put on the books. Or say you want to write a contract speculating on the number of twins to be born in Nebraska in 2020. No problem – at a price, you will easily find an obliging counterparty. When we purchased Gen Re, it came with General Re Securities, a derivatives dealer that Charlie and I didn't want, judging it to be dangerous.

We fa iled in our attempts to sell the operation, however, and are now terminating it. But closing down a derivatives business is easier said than done. It will be a great many years before we are totally out of this operation (though we redu ce our exposure daily). In fact, the reinsurance and derivatives businesses are similar: Like Hell, both are easy to enter and almost impossible to exit.

In either industry, once you write a contract – which may require a large payment decades later – you are usually stuck with it.

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But most strategies of that kind leave you with residual liability. Another commonality of reinsurance and derivatives is that both generate reported earnings that are often wildly overstated. That's tr ue because today's earnings are in a significant way based on estimates whose inaccuracy may not be exposed for many years. Errors will usually be honest, reflecting only the human tendency to take an optimistic view of one's commitments.

But the parties to derivatives also have enormous incentives to cheat in accounting for them.

Clayton's earnings, however, will surely suffer if we are forced to compete for long against government-favored lenders. Pre-Tax Earnings (in millions) 2008 2007 Net investment income ..... $330 $ 272 Life and annuity operation ..... 2 3 (60) Leasing operations ..... 8 7 1 1 1 Manufactured-housing finance (Clayton) ..... 2 0 6 5 2 6 Other* ..... 1 4 1 1 5 7 Income before investment and derivatives gains or losses ..... $787 $1,006 *Includes $92 million in 2008 and $85 million in 2007 of fees that Berkshire charges Clayton for the use of Berkshire's credit. 12 Tax-Exempt Bond Insurance Early in 2008, we activated Berkshire Hathaway Assurance Company ("BHAC") as an insurer of the tax-exempt bonds issued by states, cities and other local entities. BHAC insures these securities for issuers both at the time their bonds are sold to the public (primary transactions) and later, when the bonds are already owned by investors (secondary transactions).

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Beware the investment activity that produces applause; the great moves are usually greeted by yawns. Derivatives Derivatives are dangerous. They have dramatically increased the leverage and risks in our financial system.

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They allowed Fannie Mae and Freddie Mac to engage in massive misstatements of earnings for years. So indecipherable were Freddie and Fannie that their federal regulator, OFHEO, whose more than 100 employees had no job except the oversight of these two institutions, totally missed their cooking of the books. 16 Indeed, recent events demonstrate that certain big-name CEOs (or former CEOs) at major financial institutions were simply incapable of managing a business with a huge, complex book of derivatives. Include Charlie and me in this hapless group: When Berkshire purchased General Re in 1998, we knew we could not get our minds around its book of 23,218 derivatives contracts, made with 884 counterparties (many of which we had never heard of). So we decided to close up shop.

Though we were under no pressure and were operating in benign markets as we exited, it took us five years and more than $400 million in losses to largely complete the task. Upon leaving, our feelings about the business mirrored a line in a country song: "I liked you better before I got to know you so well." Improved "transparency" – a favorite remedy of politicians, commentators and financial regulators for averting future train wrecks – won't cure the problems that derivatives pose. I know of no reporting mechanism that would come close to describing and measuring the risks in a huge and complex portfolio of derivatives. Auditors can't audit these contracts, and regulators can't regulate them.

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Finally, in 2006, OFHEO issued a 340-page scathing chronicle of the sins of Fannie that, more or less, blamed the fiasco on every party but – you guessed it – Congress and OFHEO. The Bear Stearns collapse highlights the counterparty problem embedded in derivatives transactions, a time bomb I first discussed in Berkshire's 2002 report. On April 3, 2008, Tim Geithner, then the able president of the New York Fed, explained the need for a rescue: "The sudden discovery by Bear's derivative counterparties that important financial positions they had put in place to protect themselves from financial risk were no longer operative would have triggered substantial further dislocation in markets. This would have precipitated a rush by Bear's counterparties to liquidate the collateral they held against those positions and to attempt to replicate those positions in already very fragile markets." This is Fedspeak for "We stepped in to avoid a financial chain reaction of unpredictable magnitude." In my opinion, the Fed was right to do so.

Source: Warren E. Buffett, Letters to Berkshire Hathaway Shareholders: 2002, 2008 (berkshirehathaway.com/letters). Excerpts © Berkshire Hathaway Inc., all rights reserved; reproduced in part for non-commercial teaching. "…" marks skipped text. The summary is original course material by Jaeyoon Yu; not affiliated with or endorsed by Berkshire Hathaway Inc.