As the fear of double dip recession in United States further catches on, one debate which will continue forever; are derivatives responsible for economic recession which led to failure of major financial institutions and leading world economies. The debate started in 2002, when world’s leading investor called derivatives as “Weapons of mass destruction”. Former Fed Chairman Allan Greenspan stated that derivatives have become so huge because it is providing some economic value to their users.

Derivatives were invented as means of insurance for the companies to separate and trade various kinds of risks. The ability of companies to adjust their business risk enhances the efficiency of capital flows in the financial markets by allowing companies to conduct their business activities in a less risky environment.

But these simple instruments of insurance has been made complex by greed of human being which has made these instruments beyond understanding of even the regulators let alone individual investors. If the regulators were aware of derivatives then why the following events did took place in the recent past.

• Nick Leeson at Barings Bank in 1995 (a £791 million loss and bankruptcy for his employer)
• National Westminster Bank PLC in 1997 (a $125 million loss)
• John Rusniak at Allied Irish Bank in 2002 (a $691 million loss)
• David Bullen and three other traders at National Australia Bank in 2004 (a $360 million loss)
• Société Générale's Jerome Kerviel's orchestration of the largest bank fraud in world history via derivatives trading (a £3.6 billion loss).
• Bankruptcy of Lehman brothers

The real danger of derivatives is the cash outlay to take a position in the derivatives market which is fraction of cash outlay to buy the underlying asset. Taking positions in 100 shares of a company in derivative market may need same cash as purchasing single share of that company in cash segment. This can be multiplied by through other derivative instruments. You are paying only fraction but exposure is increasing massively, increasing the downside risk.
Derivatives are like nuclear technology, if in the hands of terrorist the destruction is beyond imagination but if in the hands of countries like India and China, it could bring light to many villages which are still under realm of darkness. The former chairman of Security Exchange Commission, Arthur Leavitt rightly quoted that "derivatives are something like electricity, dangerous if mishandled, but bearing the potential to do good."

If derivatives are equally harmful and beneficial having a very thin line, then whose responsibility is to make the investor aware of this thin line. We know there are international agencies like International Swap and Derivatives Association (ISDA), governmental organisation like Securities and Exchange Commission (SEC) in US. Then why billions of dollars worth of capital of investors has been eroded in stock exchanges. The answer to this question is “greed” and “fear”.

“Derivatives are a simple case of greed and fear. Clients use these instruments to make money (greed) or protect them from the risk of loss (fear). Frequently, they confuse the two. Clients are fearful that they will miss out on the promised bonanza – fear of losing out on greed. Dealers also use these instruments to make money, primarily for themselves (greed). They frequently deal in WMD because they fear that if they did not then their competitors will (fear). They too it seems fear losing out on the proceeds of greed. The dealers also fear that in trading derivatives their greed will lead to losses (more fear). No one in the derivatives industry really wants to admit this. Most of all they do not want to admit this to regulators and politicians. They just might do something about it (the sum of all other fears).” Extract from Traders Guns and Money: Knowns and Unknowns in the Dazzling World of Derivatives by Satyajit Das