

Full extent of financial crisis still not known, Purdue expert says

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(PhysOrg.com) -- The depth of the current financial crisis is unknown partly because most financial institutions don't disclose they are in trouble until after the fact, a Purdue University expert says.

"The question we don't know is how deep the recession will be and how long it will last," says Sugato Chakravarty, a professor and head of the Department of Consumer Sciences and Retailing.

"The problems keep coming out in drips and drabs. Banks that have cash are leery of lending. The next couple of years could be very turbulent. The markets will be up and down. The next president, whoever he is, will have to deal with all of this."

Chakravarty says much of the current situation has been caused by credit default swaps.

"Credit default swaps are an insurance device much favored by banks and other financial institutions to cover potential losses on their loans in the event of a default, much like you and I would buy homeowner's insurance to protect ourselves from damage to our homes," he says.

"These credit default swap contracts can be sold and resold several times in the secondary markets, and no one knows if the eventual buyer 10 degrees removed has the financial wherewithal to cover the losses if the underlying security defaults. There is hardly any oversight in these markets."

Chakravarty says the swaps usually apply to municipal bonds, corporate debt and mortgage securities but have expanded into structured finance containing pools of mortgages, especially pools of high-risk subprime mortgages. The credit swap market is not regulated.

He says the problem came when there was a downturn in the housing market and thousands of subprime mortgages defaulted.

"Billions of dollars of credit default swap holders exercised their option to trigger the insurance, except there was no one on the other side to honor those insurance contracts," Chakravarty says. "There is no regulation and little you can do to enforce payment."

But Chakravarty said there is reason for optimism.

"The market always rebounds eventually, and the U.S. has deep financial resources."

Provided by Purdue University

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