Role of credit derivatives to financial crisis assignment

Business

Rode of credit derivatives Credit derivatives ??? financial instruments that allow one to assume or cede credit risk exposure. Credit derivatives are bilateral contracts between a buyer and a seller, whereby the seller sells protection against the credit risk of the reference entity (i. e. corporate, sovereign or any other legal entity which incurs debt). Credit derivatives played a major role in the financial crisis of 2008, with many banks, investment banks and insurers incurring unexpectedly large losses from credit derivatives.

In some cases, the organizations failed and others required massive government bailouts to remain solvent. From subsequent comments it became clear that many board members, risk officers and other executives did not clearly understand the risks involved in the credit derivatives they traded. Credit derivatives allow investors to express their credit more efficiently and flexibly, and mitigate (reduce) credit risk by spreading it among a wider group of investors.

But all these circumstances magnified systemic risk, especially given the difficulty of identifying counterparties and pinpointing where credit risk ultimately resided. Some complain that fair-value accounting requirements exacerbated the credit crisis for many financial institutions. But some industry leaders counter that if banks and other institutions had properly valued their risk exposures at the outset, they would have been in a better position to manage and reduce those exposures when the crisis hit.

Credit derivatives instruments made mortgage lending problems worse, shifting risk that is the basic property of derivatives in directions that became so complex that neither the designer nor the buyer of these instruments apparently understood the risks they imposed and implicated derivative owners in risky contingencies they did not realize they were assuming. Derivatives as well as mortgage-backed securities were difficult to price. I believe that Credit derivatives aren't, of course, solely to blame for the financial crisis that has helped bring down Wall Street and banks, but they made the financial world more complex and more opaque.

Ultimately, they have exacerbated the market panic, as financial firms and regulators have belatedly come to grips with the enormity of the problems. Merrill Lynch ultimately capitulated to a sale because investors had no confidence that the firm had a handle on what its problems were. When the federal government took over A. I. G. in September, it was largely because of the insurance behemoth's exposure to credit-default swaps[1]. Credit derivatives impact relating in ingoing issues

Market participants must determine whether the evolving crisis will lead to contagion and systemic risk. With the prospect of writedowns on Greek debt, the financial system must concern itself with who holds these toxic bonds. The other key technical issue in a potential restructuring is whether the restructuring would trigger (isaugti, sukelti) payments on credit default swaps (CDS) written on Greek debt. And here we come to the part of the story where market transparency (skaidrumas) is questionable.

There are two mechanisms by which CDS could inflame (astrinti) the current situation. The first is direct: CDS provide the opportunity for institutions to take positions on Greek bonds, without necessarily holding the bonds themselves. This implies the possibility that there is much more exposure to a Greek default in the system than the banking disclosures have revealed. It is easy to lament the continued lack of central clearing and reporting for the CDS market, a reform that would provide transparency on the size and nature of the market’s exposures.

The second mechanism by which CDS could rattle the markets is through a counterparty failure; that is, the failure of an institution who has sold CDS protection on Greece to make good on its obligations. Again, the analogy with 2008 is tempting, since the rescue of AIG was precipitated by the potential chaos of AIG failing to pay on its CDS obligations. Transparency is far from adequate on this point, but there are a number of reasons to be hopeful. ————————– [1] http://scienceofeconomics. wordpress. com/2010/10/18/the-financial-crisis-derivatives-financial-innovation/