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Home ► All Journals ► Social Sciences ► Economy and Society ► List of Issues ► Volume 41, Issue 3 ► Knowledge production in financial market

Economy and Society >
Volume 41, 2012 - [Issue 3](#)

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Special Feature: An important failure: knowledge limits and the financial crisis

Knowledge production in financial markets: credit default swaps, the ABX and the subprime crisis

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Abstract

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contested and sometimes precarious nature of canonical-mechanism markets, discussing disputes over how to standardize financial instruments, over the ‘fairness’ of prices and over the dependability of those prices as indicators of the economic value of financial instruments. Canonical-mechanism markets, the clashes of interests they can involve, the material ways in which prices are generated and circulated within them and their limits as generators of knowledge all need to be researched in depth.

Keywords:

- economic sociology
- canonical mechanism
- subprime crisis
- credit default swap
- ABX

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Notes

1. Also used in the context of credit derivatives.
2. Carruthers and Wilson (2003) argue that the primary motivation for their study is the need to understand the role of the state in the development of the financial system.
3. Other studies have shown that the principal component of an ABS's return is the return on the underlying assets (e.g., mortgages), and that the 'implied volatility' of an ABS is a function of the volatility of the underlying assets. This is not the case for an ABS that does not have a fixed maturity date, or for an ABS that is subject to prepayment risk. See, for example, Carruthers and Wilson (2003).



4. The 'end-user template' does not include 'implied writedown' and 'rating downgrade' as credit events (see the previous note, and also Whetten, n.d, p. 3), and does not give the protection buyer the right to end the contract early.
5. The monolines did sell a great deal of protection, but more of it was on CDOs, especially their super-senior (i.e. highest) tranches, than on the underlying ABSs (see MacKenzie, [2011](#)).
6. See the categorization of the direct and counterparty losses of the 'investment banking operations of major international banks operating in the UK' (where all global banks have operations) by the Financial Service Authority ([2010](#), p. 41 and table 5.1, p. 42). On ABS CDOs, see MacKenzie ([2011](#)).
7. For examples of the complaints, see Zuckerman ([2009](#), pp. 161–3) and Lewis ([2010](#), pp. 184–9).
8. Typically, while dealers have the right to issue marks, clients have the right to contest them, and contracts often specify that such disputes are to be resolved by gathering price quotations from dealers who are not parties to the contract. We 'spend half our time contesting the marks', said the senior manager of one hedge fund active in credit derivatives. However, he told me, formal procedures such as polling other dealers are not followed. For example, he said, "I remember one time when I saw this written [unclear] I go to J.P. Morgan and I'm interested to start with [unclear] hs, I am having to [unclear] n for me?" Only so [unclear] m I going to do that [unclear] ldman Sachs?"
9. A [unclear] February 2007, but trad[unclear] ng credit crisis. For [unclear]
10. For e [unclear] i.e. 1.54 per cent). In [unclear] ve from the protection [unclear]
- 1.54 per cent×(Notional)×(Current Factor)



where Notional is the agreed amount of protection purchased and Current Factor (which at the launch of an ABX series was always 1.00) represents the extent to which the principal of the 20 underlying tranches is reduced, either by amortization (being paid off) or by writedowns. So, for example, the annual payment for protection of \$10,000,000 (with no credit events, amortization or writedown) is \$154,000.

11. For example, on 24 February 2006, five weeks after the launch of the ABX, the 'price' of the 06-1 BBB index was 100.82 (Whetten, n.d., p. 8). That it had risen above 100 represented an increase in confidence in the underlying securities. A protection seller entering into a contract with a protection buyer at this 'price' would have to make an initial payment to the buyer of

$0.82 \text{ per cent} \times (\text{Notional}) \times (\text{Current Factor})$

where Notional and Current Factor are defined as in the previous note.

12. Even with certainty of eventual complete loss, the index will not necessarily fall immediately to zero, because the protection seller will continue to receive coupon payments until the complete loss occurs. However, the lowest ABX tranches are now illiquid, so the quoted levels of them need to be interpreted with caution.

13. A related concern was with the loan modification programmes that mortgage

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Additional information

Notes on contributors

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Donald MacKenzie holds a personal chair in sociology at the University of Edinburgh. His most recent books are: *An Engine, not a Camera: How Financial Models Shape Markets* (MIT Press, 2006); *Do Economists Make Markets? On the Performativity of Economics* (Princeton University Press, 2007), co-edited with Fabian Muniesa and Lucia Siu; and *Material Markets: How Economic Agents are Constructed* (Oxford University Press, 2009)

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