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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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In 2008, … n valuations of portfo… the ABX, a crucial n… e valuations. The p… contested proc… and outlines how the … it default swaps a… nonical mechani… s easy when analysin… es the conteste… ets, discussi… '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 useful, although more general, is the analysis of the development of credit derivatives in Huault and Rainelli-Le Montagner (2009).

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3. Other an ABS's principal), an 'implied of an ABS that doe ilure to mak '. See, for examp

4. The 'e downgrade' as credit oes not give the prot

5. The m DOs, especial 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 can be less than useful: ‘I mean, that's [nonsense], you know, you see this written [into] so many contracts, oh, “go to the market and get five bids”… I go to J.P. Morgan and say, “listen, I did this deal with Goldman Sachs”, they're not interested to start with, and you're sitting there saying, “I did this deal with Goldman Sachs, I am having trouble with my valuation, right? Can you go and provide a valuation for me?” Only so that you [J.P. Morgan] can then piss off Goldman Sachs! Well, why am I going to do that because then, I [J.P. Morgan] do a huge amount of business with Goldman Sachs?’

9. A tran ruary 2007,
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crisis. Fo

10. For e i.e. 1.54 per
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principal being paid
off) or by f
$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 per cent×(Notional)×(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 servicers, with government encouragement, had begun, in order to help mortgage borrowers who were in arrears restart payments and avoid foreclosure. The buy-side concern here was that servicers owned by large sell-side firms would manipulate those programmes in such a way that the interests of those who had bought protection on subprime mortgage securities would be damaged. In particular, loans on which modifications had been agreed would no longer be classed as non-performing, and this could av … d those loans, th … es, 2007).

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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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