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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

In 2008, the solvency of many of the world's leading banks came to hinge on valuations of portfolios of subprime mortgage-backed securities. This paper examines the ABX, a crucial new market (set up in January 2006) widely used as a guide to these valuations. The paper outlines the origins of the ABX, discusses the sometimes fiercely contested process of the standardization of the credit default swaps that underlay it, and outlines how the ABX rendered the subprime crisis visible to financial markets. Credit default swaps and the ABX are traded in a specific form of market that I call ‘the canonical mechanism’. Because canonical-mechanism markets are well regarded, it is easy when analysing them to slip into functionalism. Accordingly, this paper emphasizes the 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 useful, although more general, is the analysis of the development of credit derivatives in Huault and Rainelli-Le Montagner (2009).

2. Carruthers and Stinchcombe (1999, p. 355), identify the risk that – contrary to their intentions – their argument can be read as functionalist.

3. Other ‘pay-as-you-go’ credit events include a ‘writedown’ (a reduction of an ABS's principal, following a procedure laid down in the ABS's legal documentation), an ‘implied writedown’ (an economically equivalent reduction in the principal of an ABS that does not have a formal writedown procedure), a ‘principal shortfall’ (failure to make the full principal payment when it falls due), and a ‘rating downgrade’. See, for example, Whetten (n.d., pp. 3–4).

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 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 tranched version of the ABX, the TABX, was eventually launched in February 2007, but trading of it effectively ceased after a few months because of the growing credit crisis. For reasons of space I cannot discuss the TABX in this paper.

10. For example, the coupon rate on the 06-1 BBB ABX is 154 basis points (i.e. 1.54 per cent). In the absence of credit events the protection seller would thus receive from the protection buyer an annual payment of:

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 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 avoid (or at least delay) writedowns of securities whose pools included those loans, thus avoiding payments to those who had bought protection (Scholtes, 2007).

14. The only case of such a manoeuvre that I had reported to me concerned single-name credit default swaps rather than the ABX, and was initiated by a buy-side firm, not a Wall Street sell-side institution. The firm bought a badly troubled bond, persuaded three dealers to buy protection on it via credit default swaps, and then bought the outstanding balance of the underlying loans, thus pocketing the large up-front sums that the dealers had paid for protection with no risk of having to pay out on that protection.

Additional information

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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)