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Donald MacKenzie The cultural arbitrage that drove the credit boom

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Beneath all the toxic acronyms lies a basic cultural issue

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INSIGHT

Of all the "toxic assets" at the heart of the credit crisis, one kind proved most toxic of all: collateralised debt obligations made up of asset-backed securities (or ABS CDOs to those in the know).

They are like a kind of Russian doll. A CDO, or collateralised debt obligation, is an instrument that involves packaging a pool of assets and selling tranches of securities based on the cash flow from the pool. In an ABS CDO, each of those underlying assets is itself a tranche of an asset-backed security, which is already a packaged instrument, most commonly based on a large pool of mortgages. By 2005, ABS CDOs had become the main source of demand for the riskier tranches of mortgage-backed securities, and the International Monetary Fund calculates that by October 2008 losses on these Russian-doll instruments totalled $290bn, the largest single category of the losses that triggered the global banking crisis.

Why were ABS CDOs so toxic? For the past 10 years, I have interviewed many market participants for my research on the sociology of financial markets. One thing that is striking is that different groups of participants understand financial instruments in very different ways and each with their own "evaluation cultures", their own distinctive ways of making sense of and valuing financial instruments.

ABS CDOs fell into the gap between two evaluation cultures. ABS specialists and CDO specialists each have rich and sophisticated ways of understanding financial instruments, but those ways were, and are, different, in spite of the fact that ABS and CDOs are instruments with very similar structures.

A gap between evaluation cultures such as this is enticing, because money - arbitrage profits - can be made there. Often, this involves the modern equivalent of the age-old practice of buying something cheaply in one culture and selling it expensively in another. What was being arbitraged by ABS CDOs was an unintentional side-effect of the way ABS CDOs were evaluated, especially by the rating agencies, using the techniques of the CDO culture. These were honed originally for the analysis of a different kind of CDO, in which the underlying assets were loans made to corporations or bonds issued by them.

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The models the agencies employed made it possible to create an ABS CDO that was mostly triple A rated out of tranches of mortgage-backed securities with only low investment-grade (triple B or triple B minus) ratings. This arbitrage was not magic or alchemy, but the effect of the assumption of only modest levels of correlation - somewhat higher than those assumed for corporate loans or bonds, but still not very high - between different mortgage-backed securities. Everyone understood that default on any particular triple B or triple B minus tranche was perfectly conceivable, but ABS CDOs could withstand limited numbers of these defaults. Crucially, the models implied that large scale defaults were unlikely, so permitting triple A ratings. It's rather like how it is perfectly possible for one coin to turn up tails, but very unlikely for 20 independently tossed coins all to do so.

In retrospect, the chain of disaster is clear: ABS CDOs helped permit mortgage-backed securities to become riskier, and those securities in turn facilitated ever riskier mortgage lending. But it was not seen clearly at the time because ABS CDOs fell into the gap between cultures. ABS specialists, for example, were certainly worried by the deteriorating quality of US mortgage lending and of the resultant ABS, but paid little attention to the potentially precarious situation of ABS CDOs. Those whose job it was to construct the latter had to turn a blind eye. As one of my interviewees put it, "So, you know, you talk to people [CDO arrangers], and they're complaining about the quality [of ABS] . . . But they've got a mandate to do the CDO, they've got to get it done. They've got to buy something because they want their fees."

CDO specialists did not spot the growing danger for different reasons.

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Some looked down on ABS specialists as mathematically unsophisticated. The understanding that ABS specialists had of the institutional realities of US mortgage lending was not sufficiently valued. In the months before the crisis, CDO specialists also had their anxieties, but these focused on innovative new products, not the hugely larger volumes of ABS CDOs, which were a "very boring part of the market", as another interviewee said. The gaps between evaluation cultures are dangerous as well as enticing. To understand them, we need the techniques of the sociologist or anthropologist, not just the economist. We need to talk to people, to grasp how they think and calculate, to try to get "inside their heads", to find out how their evaluation cultures differ.

By doing so, we'll also discover things that are not said, tacit assumptions that are made, people who are not spoken to, and the perilous gaps that in consequence open up.

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