Derivative Ethics

The SEC case launched against Goldman Sachs arising from the ABACUS synthetic CDO deal raises, at the very least, some serious ethical questions about some investment banking practices. Unfortunately, the complexity of the transaction involved obscures the fact that it is merely a variant of the investment banker's role as a matchmaker of demand and supply in financial markets.

Investment banks have traditionally played the role of matchmaker bringing those with a demand for funds, such as a company wishing to issue debt, together with investors able to supply funds. That process is subject to regulation, involving required disclosures, independent expert opinions and audit and third-party ratings. Also important is the investment bank's concern for its reputation. If it "duds" investor clients by selling them bad investments, it will struggle for future business.

The ABACUS transaction relates to matchmaking in the market for highly levered bets on the future value of particular financial instruments – in this case residential mortgage backed securities (RMBS) constructed from sub-prime mortgages. If an investor/ speculator client of an investment bank wants to bet on such securities falling in value, where is the line which should not be crossed in attempting to accommodate that demand?

There are four slippery steps along the path the investment bank might tread in its pursuit of profit from "doing a deal".

In such a situation, the client will want to buy a Credit Default Swap (CDS) on the security in question (eg a particular RMBS) where he pays a fee, and in the event of the RMBS failing (through enough sub-prime mortgage borrowers defaulting) strikes a jackpot payout from the counterparty who sells the CDS.

Generally, the investment bank would attempt to meet this demand, most likely by selling the CDS to him and hedging its position by finding another entity willing to sell the same CDS to it (and generating some income on the spread involved).

Taking this first step doesn't raise any ethical issues – although some might object to the practice of unrelated third parties betting on the possibility of mortgage borrowers defaulting. But to many economists, such betting is justifiable because the prices (odds) established provide, arguably, market signals which may help guide resource allocation

But, it may be that there are few such entities out there willing to sell the CDS for the level of fee income that the client and the investment bank is willing to pay.

The second slightly slippery step is for the investment bank to construct an investment product which implicitly incorporates sale of the CDS into its structure. A special investment vehicle (SIV) is established which raises funds from investors, invests those funds in government bonds and also sells a CDS on the RMBS (the reference asset) to the investment bank for fee income.

The investors are offered a high interest rate equal to the interest on the government bonds plus the fee income from the CDS sale, but are at risk of doing their dough if the reference asset (the RMBS) fails and a payout on the CDS is required.

Are there ethical concerns here? It might be asked why it is necessary to construct such a synthetic investment product in order to get investors to implicitly sell the CDS, and marketing strategies and investor sophistication are relevant here. Should the investment bank disclose in the offer documents why they have constructed this product – specifically that they have a client on the other side wishing to bet on failure of the RMBS? Maybe, but the client on the other side might just as easily be a commercial bank lender who is wishing to lay off some credit risk purely as part of prudent risk management strategies rather than as a speculative bet on a failure.

The third slippery step occurs where the client is not sure which of many RMBS will fail and wants to take a "trifecta" type bet on some package of RMBS which improves the probability of winning. This depends on the correlation of default probabilities, and the investment bank can structure an investment product where the implicit CDS is on a package of RMBS which has a high chance of a failure – to the benefit of the client and detriment of the investors.

Is that unethical? It's unlikely to win friends amongst the investors if the chickens come home to roost, and may harm the investment bank's reputation and scope for repeat business.

It can be argued that the investors are consenting sophisticated adults who should be able to assess these risks and determine whether the interest rate offered was adequate for the risk. But realistically, as the GFC has amply demonstrated, probably not – and whether investment banks should seek to profit from such investor inadequacies is clearly an ethical (and perhaps regulatory) question. Moreover, there are certainly conflicts of interest in the matchmaking process involved here that put the interests of one client above those of others.

The fourth slippery step is where, as apparently occurred in the ABACUS transaction, the client wishing to bet on RMBS failures is given a role in structuring the investment product in order to increase the probability of his bet paying off. That's, at best, a conflict of interest, and warrants disclosure. And the client apparently paid the investment bank some $15 million for constructing the ABACUS. A nice little earner – but who's counting the cost?

Kevin Davis
Professor of Finance, The University of Melbourne
Research Director, Melbourne Centre for Financial Studies
April 29, 2010