THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

Department of Accounting

Commodification of Risk and Determinants of Credit Supply in U.S. Mortgage-Backed Securities Markets

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Abstract

It is generally accepted that one of the most important proximate causes of the financial collapse of 2007 was the massive expansion of credit supplied to housing activity. As opposed to theories of credit inflation that foreground macroeconomic phenomena and monetary policy, this paper examines the 2007 crisis through institutional analysis and concepts tracing to the sociology of knowledge. I argue that commodification of default and credit risks—trading and pricing such risks through market exchange—was an important determinant of credit boom in the U.S. financial markets. The institutional mechanisms connecting commodification of risk to credit supply were the legitimization and adoption of leverage regulation based on risk assessment by private financial intermediaries and risk pricing in financial markets. By examining various credit enhancement techniques through SEC filings and rating agency publications, I show how and why market-based risk assessment was prone to a self-feeding expansionary cycle in housing mortgage markets. My analysis complements previous investigations that emphasize deregulation, arbitrage, and the role of credit rating agencies. However, it differs from the existing literature in its emphasis on the causal connections between institutional transformations— commodification of risk and regulation of leverage—and credit supply.