Markets overstretched to deal with subprime crisis

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A few weeks ago, the Boston Globe carried a story on a situation that frustrates people commuting by bus to Cambridge's Harvard Square. After a wait of what seems like an eternity for a bus, a bunch of them suddenly appears. To add insult to injury, a crowded first bus is typically followed by relatively empty ones.

Buses start their routes at regular 10-minute intervals as programmed. The problem is that the already stretched bus network is unable to absorb unanticipated changes in the flow of passengers.

If the first bus in any particular sequence finds that it has to pick up a larger-than-expected number of passengers early in its route, it is likely to have to do so again at most of the subsequent stops. As a result, the bus slows, gets overcrowded and is soon joined by other buses that cannot pass it because of the city's narrow streets.

This simple dynamic is helpful for thinking about the complex forces that have shaped the recent market turbulence. Specifically, it sheds light on how dislocations that started months ago in the subprime sector have now evolved into a generalised deleveraging and derisking of balance sheets, disrupting liquidity and forcing central banks to inject funds.

Let us start from what have correctly become two pieces of conventional wisdom in today's financial industry. First, market segments with very different fundamentals are linked through the powerful combination of common investor ownership, co-existence in pooled vehicles and the rebundling of similarly rated derivative tranches. Second, the persistence up to a few weeks ago of unusually low volatility and risk premia encouraged an overproduction and overconsumption of risk assets, including through the leveraging of balance sheets.

Similar to the Cambridge bus network, this overstretched market construct proved incapable of dealing with the cascading of difficulties inflicting subprime. Specifically, as market participants digested the elements of the subprime debacle (the first "bus" in the sequence), concerns mounted about "parameters" that are normally taken for granted – particularly, the ability to value and transfer property rights.

Such concerns strike at the heart of any market system since they speak to the ability of buyers and sellers to get together and transact using a market-clearing price. The result is growing congestion as the two sides of markets fail to interact productively.

In today's leveraged world, lenders holding partial collateral are understandably reluctant to wait lest their claims are made worthless. Indeed, most of them possess contracts that allow them unilaterally to impose their version of valuations in periods of market stress. This leads to the bunching of leveraged players having to raise liquidity to meet margin calls.

Today's market turbulence is amplified by the fact that banks, which constitute the central nerve system of finance, are finding themselves on different sides of various stressed financial relations – for example, through their prime brokerage activities, warehousing of structured products, proprietary trading, investment management relationships and commitments to leveraged buy-out financing. It is, therefore, not surprising that monetary authorities round the world decided last week to open the liquidity pumps.

By weakening the self-reinforcing tendencies inherent in any rapid derisking of leveraged balance sheets, these "crisis management" operations stand a good chance of helping markets find a bottom and should be quickly accompanied by strengthening market infrastructure.

Such "crisis prevention" steps to be adopted by market participants involve encouraging sustainable improvements in risk analytics (including the manner credit ratings are assigned), the development of a broader set of term-financing vehicles for leveraged players, better supervision of complex instruments and retooling valuation methodologies. Without this, the inevitable future recurrences of technical markets disruptions will no longer be confined to Wall Street: they will also spread to Main Street by undermining economic growth, employment and price stability.

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