



Institute for
New Economic Thinking
AT THE OXFORD MARTIN SCHOOL

(/)

7

News - Did Value at Risk cause the crisis it was meant to avert?



News

Did Value at Risk cause the crisis it was meant to avert?

12 May 2016

What were the causes of the crisis of 2008? We show that managing risk using the procedure recommended by Basel II, which is called *Value at Risk*, may have played a central role. We make a very simple model for the banking system that captures the key elements of risk management under *Value at Risk*. Providing the banks' only take modest risks, the financial system remains stable. But if they take higher risks, or if the banking sector gets larger, the market begins to spontaneously oscillate, in a way that resembles the period leading up to and including the Global Financial Crisis. For about 10 - 15 years prices and leverage slowly rise while volatility slowly falls, then prices and leverage suddenly crash and volatility