

The crash of 2008: A mathematician's view

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Markets need regulation to stay stable. We have had thirty years of financial deregulation. Now we are seeing chickens coming home to roost. This is the key argument of Professor Nick Bingham, a mathematician at Imperial College London, in an article published today in *Significance*, the magazine of the Royal Statistical Society.

There is no such thing as laying off risk if no one is able to insure it. Big new risks were taken in extending mortgages to far more people than could handle them, in the search for new markets and new profits. Attempts to insure these by securitisation – aptly described in this case as putting good and bad risks into a blender and selling off the results to whoever would buy them – gave us toxic debt, in vast quantities.

"Once the scale of the problem was unmistakably clear from corporate failure of big names in the financial world, banks stopped lending to each other," says Bingham. "They couldn't quantify their own exposure to toxic debt – much of it off balance sheet – so couldn't trust other banks to be able to quantify theirs. This led to a collapse of confidence, and the credit crunch, which turned a problem in the specialised world of exotic financial derivatives into a crisis in the real world. Once the problem became systemic, government had to step in to bail the system out with vast quantities of public money."

Professor Bingham suggests that to learn more and predict financial future, we should look to our past, likening the current crisis to the 'Tulip Mania' in the Netherlands in 1636 where huge prices were paid for futures in tulips, which then turned out to be as worthless as sub-prime

mortgages today.

Even Alan Greenspan, the long-serving former chairman of the US Federal Reserve, admits that mistakes were made in the past. To avoid repeating these mistakes, we need to learn from them. This needs a new mind-set, new policies, and much more proactive regulation.

Bankers complain that the risk models they used predicted problems as dramatic as today's only every few centuries. "This is like talking about the details of how to steer a boat on a river," says Bingham, "what matters there is whether or not the river is going to go over a waterfall, like the Niagara Falls."

Source: Wiley

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