What “The Big Short” Gets Right—and Wrong

By Amine Ouazad , INSEAD Assistant Professor of Economics

For a Hollywood movie, “The Big Short” is surprisingly sophisticated about what caused the financial crisis, but it fumbles a few key issues.

Recently, I took a small break from my research work to see the movie *The Big Short* with my wife, a real estate consultant. Despite its star-studded cast, this film, I was afraid, would bore her. Its subject is hardly typical for Hollywood entertainment: A small group of traders (based upon real-life figures) who figured out early on that Mortgage Backed Securities (MBSs) had AAA ratings that were too good to be true. They make a fortune by betting against the mortgage market. As it turned out, my wife and I were pleasantly surprised at the movie’s enjoyable, accessible presentation of what could have been dismally dry material.

Who’s to blame?

Not all economists felt positively about the movie, however. *The Big Short* has reignited debate concerning who is ultimately to blame for the financial crisis. Some right-leaning columnists have **fiercely criticised the film** for focusing too much on chicanery in the finance sector while neglecting the role of government regulators as well as the subprime risk assumed by Fannie Mae and Freddie Mac. “*The Big Short* is entertainment, not the truth”, said one commentator.

I beg to differ, at least in part. It is true that in the entire film we never see a banking supervisor or any other representative of a government oversight agency. This is arguably a major omission. However, the movie is less concerned with fixing blame on a single source than with tracing a multitude of factors that led to the financial meltdown. And in doing so, *The Big Short* gets quite a lot right.

The hidden perils of pooling

For instance, the movie takes great pains to describe CDOs (collateralised debt obligations) accurately, going so far as to show the textbook definition of the term onscreen. The protagonists perceive what the financial establishment largely did not: Pooling mortgages together reduces default risk only theoretically. If all assets of the securitised product undergo simultaneous shocks, as happened with the financial crisis, packaging does little to reduce risk. The movie wittily compares the pre-crisis U.S. housing market to a tower of Jenga blocks that is just a few chinks away from complete collapse.

Fannie and Freddie aren’t the culprits

As the film implies, there are good reasons to believe that the GSEs (government-sponsored enterprises) Fannie Mae and Freddie Mac bore less direct responsibility than the private-label securitisers. Most subprime loans in the years immediately preceding the financial crisis were private-label backed. Fannie and Freddie did have securitisation goals (set by Congress) but these were for either underserved areas or low-income households. And careful estimation of the impact of these thresholds on mortgage supply suggests there isn’t much happening there. These housing goals don’t seem to be the reason for the crisis. The stage was set for catastrophe when the GSEs withdrew and private label securitisers took their market share, with much less rigorous securitisation practices.

The film shows us how slipshod the banks’ vetting process had become in scenes where the short-sellers delve into the specifics of these loans. They meet Florida homeowners who obtained a mortgage with no proof of income, and mortgage brokers who boast about “NINJA loans” – an acronym for no income, no job, no assets. This is an authentic portrayal of the irrational belief in ever-rising housing prices that fuelled the housing bubble — which has precious little to do with Fannie and Freddie.

What’s missing

No two-hour movie could do complete justice to the financial crisis, and there are some important things *The Big Short* overlooks. I address one of these in a forthcoming paper in *Review of Economics and Statistics*: the preferential capital treatment given to securitised products by accounting rules such as the Basel agreements. In plain English, they get a lower coefficient in the calculation of the capital ratios. That’s a substantial incentive to package products in CDOs.

Also, the movie’s emphasis on Wall Street over Washington means that we get no discussion of the 1990s legislation that arguably created the conditions for the crisis. A proper historical analysis would have to mention, for starters**, the loosening of restrictions on interstate banking** that enabled the financial sector to increase their supply of mortgage credit on a national scale.

The Big Short perhaps cops out when it refuses to seriously question how much the banks knew about the risks associated with the financial products they were pushing. Its story is ultimately oversimplified, featuring wised-up hedge fund managers, greed-blinded bankers and regulators asleep at the wheel. You would never know that **Goldman Sachs reportedly spent millions** shorting the mortgage market in a similar manner to the traders in the movie, even while it was aggressively selling those same securities to clients. Though the “revolving door” between the public and private sectors is mentioned as a possible cause for regulatory inaction, the film doesn’t go into specifics about the **very powerful government connections** that some say saved Goldman Sachs from going the way of Lehman Brothers.

In a sense, the Washington-Wall Street binary is a false one. That is a distressing story Hollywood has yet to put on film.

Amine Ouazad *is Assistant Professor of Economics at INSEAD.*

Follow INSEAD Knowledge on ***Twitter*** *and* ***Facebook***

Find article at

https://knowledge.insead.edu/economics-finance/what-big-short-gets-right-and-wrong

About the author(s)

Amine Ouazad Amine Ouazad was an Assistant Professor of Economics at INSEAD. He is now a professor at Ecole polytechnique.