'The Big Short' Is No Tall Tale

By Kerry Pechter *Wed, Dec 30, 2015*

'The Big Short,' in which the actress Margot Roddie (above) provides exposition from her bath, is an excellent docudrama based on Michael Lewis' bestseller. It blames the financial crisis on private-sector fraud and stupidity, not on ACORN, the GSEs or Barney Frank.

"The Big Short," the just-released film based on Michael Lewis' nonfiction bestseller about the 2007-2008 mortgage bond meltdown, doesn't blame the financial crisis on Fannie Mae or Freddie Mac. Or Bill Clinton or on the community activists at ACORN, as several histories of the Great Recession do.

This reality-based drama instead blames the crisis mainly on stupidity, herd-mentality and moral hazard among Wall Street bankers and traders. Neither the book or the movie has a hero, only winners—the raffish hedge fund types who got nine-figure rich by convincing complacent bankers to take the other side of a very large bet against mortgage-backed securities.

To the extent that the movie divines the ultimate source of the global financial crisis, its Patient Zero is Lewis S. Ranieri. If you have a long memory, you may recall that Ranieri was the legendary Salomon Brothers bond trader who invented mortgage securitization during the topsy-turvy 1980s. He played a big role in Lewis' first book, *Liar's Poker*.

But what of Fannie Mae and Freddie Mac, the government-sponsored entities (GSEs) whose purchases of subprime mortgages were central to the crisis? A lot of smart people believe that overzealous government lending policy, mediated by the GSEs, caused the crisis. In *Fragile by Design*, for instance, their excellent 2014 book on the crisis, Charles Calomiris of Columbia and Stephen Haber of Stanford pin the tail on a "political bargain" between the big banks and the Association of Community Organizations for Reform Now, or ACORN.

Their version of the crisis, which has wide currency, goes like this: In the 1990s, big banks wanted to merge. ACORN's activists, armed with the 1977 Community Redevelopment Act (CRA), threatened to torpedo the mergers unless the banks channeled $850 billion in credit through community organizations and committed an "additional $3.6 trillion in CRA lending to underserved areas or low-income communities" between 1992 and 2007.

The activists then pressured Congress to mandate Fannie and Freddie to buy the sub-prime loans made to credit-unworthy individuals or in depressed communities. The GSEs bundled up the loans, divided the bundles by seniority, and marketed the tranches with the highest seniority to global institutions at triple-A prices. Soon the big banks got involved, and their demand for sub-prime loans took on a momentum of its own. Mortgage bond fever became the 21st century version of tulipmania.

An equally persuasive book, *Black Box Casino*, by Robert S. England, supports this version of the story. England traces the crisis to 1992 legislation, known as the "GSE Act," which gave Fannie Mae and Freddie Mac too much autonomy and lending power with too little oversight. In England's telling, the nitro and the glycerin that produced the crisis were first combined at Fannie and Freddie when Congress mandated them to commit most of their lending to poor people while setting their capital requirement for MBS at a mere 0.45% (a 222 to one leverage ratio) and insuring their liabilities.

"Congress basically created the framework for what would become the world's two largest hedge funds," England wrote.

It is this version of the story that "The Big Short" rejects, largely by ignoring it. Instead, Lewis paints a scenario where a trifecta of fraud, ignorance and stupidity in the financial industry pumped an otherwise garden-variety housing boom into an epic catastrophe. (Though slightly didactic, the movie does a particularly good job of dramatizing the anxieties of dealmakers, including the ironic moment when the Big Shorters realized that a successful bet on the end of the financial system might never pay off.)

Having read *The Big Short*, and lots of other books and scholarly articles that support its version of the crisis, I find its anti-banker version of the crisis more credible than the anti-government version. The idea that community activists had the power, even with allies in the government, to blackmail huge banks seems preposterous. It contradicts much of what I've seen first hand.

For instance, in my own community during the 2000s, I saw cornfield after cornfield replaced by the printed circuits of tract mansions. In my own mailbox, I received an endless series of glossy, four-color junk mail solicitations for pre-approved six-figure loans with no money down and three-figure monthly payments. Clearly, something rotten was afoot.

If the government were in fact forcing money into poor neighborhoods, I would expect to have seen low-income housing projects blossom, and observed homeowners replace renters in poor and middle-class neighborhoods. But the opposite occurred. We saw the construction of thousands of McMansions on rural land and a rise in renter-occupied houses in middle-class urban neighborhoods.

Indeed, in the small city where I used to live, real estate brokers were buying up rowhouses and *renting* them to poor people. (My once 100% owner-occupied rowhouse neighborhood deteriorated in this way.) We eventually moved to the country. In my new neighborhood, one large home has stood empty for five years because the doctor-nurse couple who owned it, along with two other homes, defaulted on their loan).

Government policies or rules may well have provided conditions necessary for the crisis to germinate, but they were not sufficient. Common sense dictates that the crisis also required the massive exploitation of the loopholes by those who had the most to gain from exploiting them. That would be the mortgage brokers and asset securitizers.

Tellingly, Calomiris and Haber reveal in *Fragile by Design* how the original low-income housing program morphed into a McMansion program. Once Fannie Mae and Freddie Mac enabled the lowering of mortgage underwriting standards, those lower standards “applied to everyone,” they wrote.

Thus, by 2006, “46% of first-time home buyers put down no money at all, and the median first-time buyer put down only 2% of the purchase price… The result [of such “inconceivably lax” rules] was the rapid growth of mortgages with high probabilities of default.” Had lending been confined to the poor, we wouldn’t have had nearly as big a boom—or as big a bust.