The Big Short

### What was the Big Short?

This big short is based on the housing crisis of 2007-2008, starting in 2005, with the booming U.S. housing market. It sounded alarms in many a fortunate investor, going against the grain, that this market was evidently a housing bubble (an **asset** **bubble**).

A housing bubble is a rapid increase in home prices caused by rising demand, bursting when demand falls but has an ever-growing supply.

To ‘**short**’ implies to bet against something, usually based on predicting the failure of a risky product. Transferring this risk - encompassing what you hold - to someone else is possible, facilitated through a payment for taking it on. Somewhat like an insurance policy, a third party agrees to pay out if your product loses its value. This is called a **credit default swap**.

The Big Short used banks as the third parties in a credit default swap, to short the housing market.

### Mortgages and The Wall Street: what do they have to do with each other?

**Securitization**

Financial institutions, large ones generally, pool together hundreds of mortgages, issuing bonds to investors with those assets as backings.

A **collateralized debt obligation (CBO)** gathers what usually are the riskiest mortgage bonds, corporate bonds and other types of debt, to assemble a new “tower” of bonds, which helps them look attractive to potential investors.

A more bond-like investment in this case, specialised to a group of mortgages alone, is a **mortgage-backed security (MBS).** Those who choose to invest in MBSs receive interest payments at a fixed rate based on mortgage payments, fluctuations depend on whether the homeowners pay early, refinance their mortgages or default (fail to pay) on these loans.

CDOs and MBSs are both financial instruments, and some MBSs can be CBOs, but neither are marketed to individual investors.

MBSs are then combined to form a “trust”, bought into by investors. Sometimes they are specialized to have tiers. Some tiers have only the highest quality securities, i.e. ones with the safest mortgages, being issued to the least risky borrowers, other lower tiers include subprime mortgages. Investors invest their money in a tier of their choosing. AAA-rated funds are the least likely to default, hence it’s only logical that pension funds are always required to be in them. Investors with more of an appetite for risk might choose a BBB rated tranche, with hopes for higher returns.

**Tranches** are payments made by homeowners, divided into different pieces, forming the basis of mortgage bonds.

Why Bother With Securitization?

A mortgage is a risky asset, these mortgage bonds spread out its risk. This brings more capital to the housing markets, which in turn helps homebuyers by making mortgages more affordable. Hence, even after the financial crisis detailed in this movie, very few advocate to thoroughly change the MBS market.

### Why Did the Market Collapse?

**The Wall Street’s Greed**

The formation and abuse of these mortgage bonds are primarily why the situation crumbled. Banks started filling up bonds with risky mortgages to make more money through investments.

High-risk MBSs were involved in CDOs, and these CDOs were still rated AAA. Why? Rating agencies believed in the safety of numbers, multiple high-risk mortgages combined seemed a good bet for investors.

Banks then started making hybrid secondary CDOs using parts of those already created. Subsequently, synthetic CDOs were made (credit default swaps), acting as insurance against people defaulting on their loans. No one believed these loans could default, and so the process of creating secondary CDOs went on, till people couldn’t pay their mortgages. The entire tower of CDOs, having been built on an unsteady base, came crashing down, and those who profited off of its demise bet on it (shorted).