Could 'The Big Short' happen again?

Breaking down one of this year's Best Picture nominees

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Key Takeaways

- The government, lenders and Wall Street have taken steps to ensure that the Great Recession won't happen again.
- However, borrowers today are no more educated than they were eight years ago.

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The movie *The Big Short* — up for five Academy Award nominations on Sunday, including Best Picture — has thrust the mortgage and real estate markets into the spotlight again. It does an excellent job of explaining very complicated financial issues while also powerfully conveying the emotionally devastating effects of the collapse of the real estate market and economy in 2008.

Some of the most poignant scenes in the film show how people lost their homes, jobs and even their lives as the mortgage and real estate bubbles imploded.

Almost eight long years have passed since the film's era, and both the real estate market and economy have rebounded. Nothing will erase the pain and anguish experienced by millions of borrowers who lost their homes but a stabilized mortgage market, improving property values and surging home sales show how far we have progressed since the market collapsed.

Whereas eight years ago the mortgage market was dominated by plummeting property values, skyrocketing foreclosures and lender failures, today, industry experts credibly debate if bubbles are forming in certain housing markets.

Relaxed requirements and aggressive lending programs

Recently, we have seen multiple examples of relaxed lender requirements and more aggressive mortgage programs. Lenders have introduced mortgage programs that require no down payment or credit scores for selected borrowers.

Quicken Loans is aggressively promoting its Rocket Mortgage program that promises a home loan with the click of a button. Interest-only mortgages rebounded in 2015 after being left for dead several years ago. Adjustable rate mortgages (ARMs) are eligible under Fannie Mae's recently launched HomeReady Mortgage Program (https://www.fanniemae.com/singlefamily/homeready?utm_source=GOOGLE&utm_medium=cpc&utm_term=fannie%20mae&utm_campaign=Fannie%20Mae%20l%20Brand) for low-to-moderate income or credit-challenged borrowers (although most HomeReady participants will likely select fixed-rate mortgages). Regulators also reduced mortgage waiting periods following adverse credit events, such as a short sale or foreclosure.

Booming home prices in many cities and loosening borrowing standards make us wonder if we have already forgotten the painful lessons of 2008 and lead us to ask the question: Could *The Big Short* happen again?

Examining how the four primary constituents that comprise the mortgage market — the government, lenders, Wall Street and borrowers — responded to the meltdown enables us to evaluate what has changed between 2008 and today and answer that question.

The government

It is fair to say that the federal government responded to the mortgage market crash with a vengeance. New government regulations (//www.inman.com/2015/10/06/10-questions-you-should-ask-lenders-regarding-trid/) are designed to protect borrowers and make lenders more accountable. Regulations require lenders to demonstrate that borrowers can pay back their loans, and riskier mortgage programs, such as option ARMs that enticed uninformed or aggressive borrowers with low teaser payments, are prohibited.

These regulations have also severely restricted the mortgage broker and limited borrower lender options but that is a topic for a different article. We can argue the effectiveness of the government's response to the mortgage disaster, but the new rules have ended the days of strippers using no income, no assets option ARMs to grow their real estate portfolios.

Lenders

The fortunate mortgage lenders that survived the market crisis also reacted strongly. Either in response to government regulations or on their own volition, lenders significantly tightened lending standards. Lenders actually required 20 percent down payments (//www.inman.com/2015/11/20/down-payments-arent-holding-back-buyers-says-lendingtree/) and focused on borrowers with superior credit profiles.

For several years it became incredibly challenging, if not downright painful, to get a mortgage. Dealing with lenders felt like hand-to-hand combat, and if you were self-employed or an independent contractor (like the stripper in *The Big Short*), forget about it.

Despite several recent cases of relaxed lending standards, getting a mortgage remains challenging for many borrowers. Saving for the down payment required by lenders for conventional mortgages represents a significant obstacle for borrowers, especially first-time homebuyers.

Perhaps dealing with lenders today feels more like a proctology exam (a necessary but unpleasant experience) than hand-to-hand warfare, but the easy lender money has certainly dried up.

Wall Street

Which brings us to Wall Street — the source of the financial fuel that powered the market bubble and the lightning rod for the financial meltdown according to many industry experts, politicians and certainly the producers of *The Big Short*. An easy and popular target, the money men depicted in the film were, at best, unethical, avaricious enablers — and at worst dirty, rotten criminals. (*The Big Short* acutely highlights that only one financier has been convicted of criminal activity stemming from the crisis).

The collapse of AIG, Bear Stearns, Lehman Brothers and Merrill Lynch caused hardship for thousands, but many argue that no pain or punishment is too severe for unscrupulous bankers. I tend to believe that leopards never truly change their spots; however, in response to intense regulatory pressure Wall Street has adopted reforms designed to prevent another market collapse.

Industry consolidation, increased capital requirements, retrenched trading operations and greater oversight should enable Wall Street to weather another financial storm, although I doubt anyone wants to test “Too Big to Fail.”

Borrowers

While the government’s, lenders’ and Wall Street’s roles in, and reaction to, the market collapse are identifiable and open to harsh criticism, the role the borrower played is more ambiguous.

Were borrowers greedy or ignorant? Were they exploiting a bubble-driven market opportunity or being exploited by predatory lenders and other industry charlatans?

Millions of uninformed borrowers got mortgages they did not understand and could not afford. (https://twitter.com/share?

text=Millions+of+uninformed+borrowers+got+mortgages+they+did+not+understand+and+could+not+afford.&url=//www.inman.com/2016/02/26/could-the-big-short-happen-again/)

Wherever you fall in that argument, there is little debate that millions of uninformed borrowers got mortgages they did not understand and could not afford. The resulting pain from countless foreclosures tarnished the American dream of owning a home and provoked borrowers to pull back. The psychological hangover from the bubble bursting, combined with many factors including stricter lending standards, caused home ownership to sink to an all-time low in 2015.

Borrowers have become more gun-shy but have they become more informed? A recent survey of mortgage borrowers by FREEandCLEAR (https://www.freeandclear.com/) suggests no. When asked what percentage of their gross income borrowers should spend on monthly housing expense and debt, only 13 percent selected the correct answer (43 percent is the debt-to-income ratio (https://www.freeandclear.com/guides/mortgage/borrower-debt-to-income-ratios.html) most lenders use) and 30 percent indicated they did not know.

Understanding what size mortgage you can afford is the first step in the mortgage process so the lack of awareness on this topic demonstrates how uninformed borrowers remain. The government can impose regulations and banks can enforce lending standards, but ultimately, it is the borrower's responsibility to get a mortgage they understand and can afford. And as *The Big Short* so accurately and agonizingly depicted, borrowers, not the government, lenders or bankers, pay the most severe penalty for being uninformed.

A better understanding of the responses by industry stakeholders to the mortgage crisis allows us to return to the question at hand: could *The Big Short* happen again?

Based on the measures taken by the primary industry participants, the answer is "probably not."

But are mortgage borrowers any more informed today than they were eight years ago? Probably not.

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