The Big Short: Inside the Doomsday Machine

Michael Lewis

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Michael Lewis has written an engaging and entertaining book that might be thought of as *Liars Poker II* (a sequel to his 1989 bestseller). In the original story, written about his stint at Salomon Brothers in the late 1980s, his thesis was that he was a fraud and had no business being in the business. His thesis in this book is that the leaders of Wall Street banks were also frauds that had no business leading their firms. Beyond that, he continues his general critique of the industry for taking the wrong turn in the 1980s by misaligning industry participants' incentives away from customers' interests. As he points out, protagonists of his story who were right and those who were wrong walked away rich from the carnage of 2007–2008. Why, he asks, do you need to make smart decisions when you can get rich making dumb ones?

His story begins with a banking analyst named Meredith Whitney who became famous for calling out banks in general, and Citigroup in particular, for the toxic assets they were holding both on and off their books. Whitney, in turn, steered Lewis to her mentor, Steve Eisman, who was one of the few who correctly saw that the subprime lending market was poised to collapse and bet accordingly. Eisman and his team, consisting of analyst Danny Moses and trader Vinny Daniel, are the primary characters in the tale. Also followed throughout are Michael Burry (of *The Greatest Trade Ever* fame), the M.D.-turned-hedge-fund manager who in 2003 was the first to write about the impending subprime disaster; and the principals of Cornwall Capital—Charley Ledley, Jamie Mai, and Ben Hockett—who in a couple of years multiplied $110,000 by a factor of 2,000 (to $205 million).

Lewis has a gift for seeing the big picture as well as a talent for detailing the particulars of a narrative, which enables him to maintain the reader's interest and attention even while dealing in financial arcana. With the mortgage bond, he observes broadly, Wall Street extended itself into the debts of ordinary Americans (as opposed to corporations): first the solvent half of the population, then fatefully the less creditworthy half. Lewis peppers the story throughout with pet liberal theories by placing them in the mouths of his protagonists, such as Eisman's that subprime mortgage lending was partly a response to growing income inequality, as the United States' skewed income distribution resulted in more subprime customers.

That peccadillo aside, financial innovations such as interest rate swaps and credit default swaps (CDS) undeniably exposed Wall Street firms and others to each other's credit. Credit default swaps on mortgage bonds are merely a contract between counterparties obligating one side to make annual premium payments and the other to pay out the full amount of a bond if the mortgages inside of them go bad (i.e., if home borrowers default on their mortgage loans in sufficient number to sink the debt obligation). If the mortgages performed, purchasers of the CDS would be obligated to continue making payments until they were paid off or refinanced. Credit default swaps could be contracted on mortgage bonds, or collateralized debt obligations (CDO). To understand Lewis's

story and what happened in financial markets and to the economy, some explanation of the process is necessary.

Briefly, loans were originated to homebuyers and sold to financial intermediaries that would package them into bonds. The best of the mortgages were packaged and *tranched* (French, for "sliced") into bonds that, because of diversification, the credit agencies (S&P, Moodys, and Fitch) would rate as AAA (the same as a Treasury bond), AA, and so on. Tranches consisting of the worst of these mortgages would be rated beneath "investment grade" (e.g., BBB and below), which meant that banks, insurance companies, and other big buyers of mortgage bonds were not permitted to purchase them. The solution for Wall Street firms desirous of selling these noninvestment grade tranches was to repackage them into yet another diversified pool. This new pool was called a CDO. Because these BBB rated tranches were newly diversified into bigger CDO pools, the credit rating agencies would deem roughly 80 percent of them to be AAA rated. Thus, the same mortgages that were unsellable in tranches of mortgage bonds would, by virtue of CDO repackaging and rerating, be eligible for purchase by institutions. Naturally, this did not change the precariousness of the underlying mortgages—merely the outward appearance of them: a fact lost on the ratings agencies that made it all possible. Lewis comments that formerly, financial innovation served to make markets more efficient, whereas in this case, it served the purpose of hiding risk (occulting transparency) by complicating it.

The creation of these securities, and complex derivatives based on them, generated enormous fees for the investment bank involved. Thus, bankers were incentivized to create more and more of them as well as invent additional products, which removed obstacles to the size of the market. Unfortunately, market participants operating on the basis of financial models did not always realize the risks they were taking because information was sketchy. Everyone trusted in the agencies' ratings. Yet, by Lewis's telling, the people in them were more like government employees than the Wall Street bankers whose products they rated. It was apparently axiomatic that people who wanted to work in the industry but could not get a job in a bank or fund would work at the ratings agencies. Their analysts wound up accepting the assumptions of the "structured finance" industry whose products they were rating. Moreover, the agencies' models had obvious holes that were exploited by the banks. For instance, they rated floating rate loans higher than fixed rate loans, ostensibly because rates that floated higher would provide higher income to the bondholders. They were impervious to the fact that a borrower saddled with higher, escalating rates was far more likely to default on the loan than one not so burdened. Thus, the agencies actually rated riskier bonds higher than safer bonds! Their models also assumed that prices for homes would always rise. Yet, they lacked data about the specific mortgages in the bond pools because the Wall Street firms would not give it to them, and they were afraid to press.

A recurring theme throughout the tale is that sellers of CDS insurance, and subprime bulls generally, believed in their positions and the market because failure would be a catastrophe of an unimaginable order. They simply did not think it could happen or that the government would allow it to happen. Moreover, history indicated that the real estate market always rose and that mortgages generally performed. Optimists had always bought

on dips. They did not know how to sell even when the only thing driving the subprime market was the CDO game.

A deeply troubling aspect of Wall Street firms' behavior, indicative of their ample conflicts of interest and easy abuse of power, was their ability to rig the prices of the vehicles they had structured and sold to the likes of Steve Eisman, Michael Burry, and John Paulson. While housing prices topped out in 2006, and problems with subprime lenders and borrowers appeared that same year, Wall Street firms dictated that the value of the CDS (mortgage-backed security insurance) they had sold decreased rather than increased. This relieved them from having to transfer money into the accounts of CDS purchasers as specified in the contracts. Yet, these firms were not willing to sell more insurance at the prices they quoted to those same purchasers. All the while, the ABX index, which tracked the value of subprime bonds, was steadily falling. Thus, firms took advantage of an esoteric, "thinly traded" (i.e., inactive, scarcely traded), and nontransparent market they had created. As long as the firms were on the unprofitable side of the trade, they used their pricing power to dictate that the value of the position had moved in their favor—a posture directly contrary to reality and ethics.

Wall Street firms suffered as their traditional businesses were squeezed by Internet brokering and became less profitable. Structured finance had become their golden goose. Their danger was magnified because the firms were leveraged 30 and 35 to 1, thus enabling them to hold huge and perilous inventories of the toxic assets they were packaging for others. Lewis argues persuasively that CEOs at the major firms did not know what was on their balance sheets. Neither could they control the pace of innovation occurring within their firms. In order to profit, they succumbed to conflicts of interest and brokered products to customers that they were taking contrary positions on at their proprietary trading desks. Yet, ultimately, bond market complexity turned against the very traders who invented it, costing masters of the universe like Howie Hubler at Morgan Stanley $13 billion on positions that they thought would profit as the subprime market collapsed. When all was said and done, and the banks were exposed to lethal risk by their own stupidity, Lewis believes that citizens of the free world were endangered by CDS on tranches of the subprime CDO. The events of the week of September 15, 2008—Lehman Brothers filing for bankruptcy; Merrill Lynch's announcement of a $55 billion loss and its sale to Bank of America; the massive market selloffs; AIG loaned $85 billion by the U.S. government to pay off subprime CDS losses ($13.9 billion of which went to Goldman Sachs, in addition to $8.4 billion they had already been paid; Goldman's CEO, Loyd Blankfein, had huddled the day before with its former CEO, Treasury Secretary Hank Paulson); the Reserve Primary Fund's freezing of redemptions and "breaking of the buck" and the subsequent run on all money market funds; the short-term spike in interest rates; and the collapse of every bank's share price under the weight of the synthetic CDO—hurt everyone and highlighted the interconnectedness of the banking system to the common man. Banking impacts credit, which in turn affects trade, which in turn affects life.

Lewis spins a good yarn, but I wonder if his jeremiad against Wall Street is completely well founded. For instance, he (like many) cites the losses and value destruction caused by

the subprime crisis and lays the blame of it largely on the CDS and the CDO. However, that cannot be completely right because for all of those losses there was a corresponding gain: for example, John Paulson's or Goldman Sachs'. Even if one considers losses to bondholders rather than derivative sellers, for every loss there is a corresponding gain to some home seller who got a high price for his property, or some homebuyer who stripped his home equity account before mailing keys to the bank. Is it correct that all this money was lost? Or, is it rather the case that it was redistributed, perhaps some to parties playing the unethical side of the fence?

Lewis is also careful to exonerate homebuyers (again, through the mouth of his characters). Of course, borrowers lied to get loans, but, says Eisman (Lewis's hero and conscience), they were coached to lie—the way that a criminal is coached by a defense attorney to shade facts to comply with the law (my example, not his). Of course, they took equity out of their homes but that was only to compensate for income inequalities and disparities in wealth. I have yet to read an account of the crisis that deals with predatory borrowers, economic free riders, housing speculators, lying applicants, and other shady characters whose immoral or amoral activity provided grist for the crisis mill. Lewis's heavy emphasis on Wall Street's sins to the exclusion of those of the beneficiaries of the liquid money streaming from financial innovation onto Main Street seems tendentious and somewhat narrow-minded.

Also missing in Lewis's indictment is an account of the general prosperity, heightened standard of living, and breathtaking technological innovation that has accompanied the era of financial innovation. He has a keen eye for the negative and has learned to make a very good living for himself by biting the hand that feeds him. I wonder if he might someday forgive Salomon Brothers for hiring him fresh out of Princeton and use his prodigious talents for observation and storytelling to sing the praises of the system that feeds him so lavishly.

—Max Torres
IESE Business School, University of Navarra, Spain