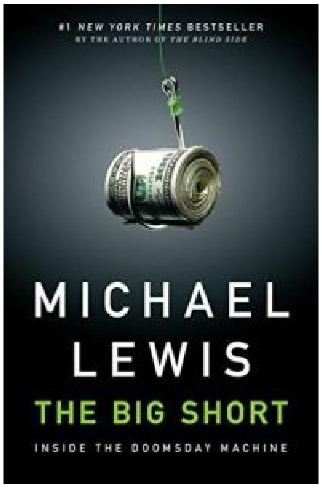

Book The Big Short

Inside the Doomsday Machine

Michael Lewis
W.W. Norton, 2010

Recommendation

If you wonder how the US suffered one of the most damaging financial crises in its history, catch Michael Lewis's definitive history of the characters and plots that led to Wall Street's undoing. He offers a black, sardonic portrayal of how smart, seemingly shrewd and very ambitious people – the elite of the elite, traders and quants alike – became obsessed with making money from a situation they didn't fully understand. Then he profiles a tiny number of people who understood exactly what was happening and couldn't believe their eyes. The book is not a chronology, but a set of portraits of these few victors, connected by the tale of the unfolding crisis. Though the book's structure is not an asset, its writing is compelling. Interestingly, the savants Lewis depicts were strange characters with weird backgrounds, spurred by a mixture of cynicism and naïveté. They would not stop asking questions, did not accept the experts' risk models, and were slow to trust anyone else's knowledge or judgment. The darkest part of Lewis's history is that no one held the major institutions that caused the crisis to account. *BooksInShort* recommends this engrossing report to bankers, traders, journalists, historians and federal prosecutors.

Take-Aways

- By 2005, Wall Street firms were heavily betting on the once-obscure subprime market.
- Artificially high housing prices, costly mortgages pushed on uncreditworthy buyers and the greedy pursuit of profit led to the 2008 financial crisis.
- Trading's ambiguous language reflected a specialized financial sector that made no sense at all.
- Credit default swaps and "synthetics" let traders take risks beyond their resources.
- The relentless, thoughtless optimism of nearly everyone in the financial system caused the inevitable subprime mortgage market crash.
- Yet no one had a crisis of conscience.
- Morgan Stanley's Howie Hubler made money on collateralized debt obligations, but underestimated their risk and ended up with record losses for his company.
- Those who saw the crisis early and profited were often misfits, antisocial or strange.
- They included investors Steve Eisman and Dr. Michael Burry, who won big on their bets.
- After the crisis, instant revisionist history incorrectly posited that it was just a "crisis in confidence." In truth, it was a crisis of greed among both bankers and investors.

Summary

Rip-Off

Steve Eisman appears on the very short list of people who both saw the financial crisis of 2008 approaching and made money on it. A graduate of yeshiva day schools, the University of Pennsylvania and Harvard Law, and a comic book fanatic, Eisman cut his chops analyzing "specialty finance" firms. He had a reputation as a truth-teller and as a man with absolutely no social skills. He was at heart a proud cynic whose curiosity and doubt enabled him to see through the ignorance, stupidity, false optimism and fraud that characterized an era on Wall Street.

> "Wall Street bond departments were increasingly the source of Wall Street profits [in part because] in the bond market it was still possible to make huge sums of money from the fear, the ignorance, of customers."

In 2002, while working as a hedge-fund analyst focused on consumer finance, Eisman came across the Household Finance Company, a 120-year-old firm that developed a market selling second mortgages. He discovered that HFC was fooling people into thinking they would pay 7% interest on 15-year, fixed-rate loans when they would actually pay closer to 12.5%. Once he uncovered this fraud, he became a crusader and spread the word to reporters, advocates and government officials. Eventually, HFC settled a $484 million class-action suit. A year later, the British bank HSBC purchased HFC for $15.5 billion. HFC's chief executive made $100 million in the deal. That provoked a coming-of-age realization for Eisman, a Republican-slowly-turned-Democrat, who began to see the effects of a lack of government regulation and the specter of a "doomsday machine."

A Bond with the Devil

By 2005, the subprime mortgage bond industry was speeding along at the rate of nearly half a trillion dollars a year in issuance. Much of the subprime bond business was built on the backs of ordinary or even poor people lured into loans they had absolutely no possibility of repaying. But the Wall Street wisdom and conviction was that housing prices would rise indefinitely – if mortgagors couldn't refinance or couldn't afford the inevitable, death-defying balloon payment, it didn't matter. In this scenario, the lender had no risk because home values were always going up and would keep going up. All the way along the financial continuum, the quantity of loans trumped their poor quality.

> "Even as late at the summer of 2006, as home prices began to fall, it took a certain kind of person to see the ugly facts and react to them."

Boardroom strategists decided to generate as many loans as possible and then feed them to the big investment banks, which would transform them into bonds. When the bonds, in turn, were in doubt, the corporate crowd believed it knew even more interesting ways to profit from losses.

To understand how events unfolded, imagine the culture of the competitive, secretive bond market. Since the 1980s, Wall Street's bond business had been its real moneymaker, dwarfing equity trading. Bonds, in general, are far more liquid than stocks and relatively unregulated. Most people do not understand them, and when subprime mortgage bonds became a bonanza in the early 2000s, their intricacy only added to their allure. The financial implosion that wrecked Wall Street in 2008 became inevitable because of the relentless stupidity of bank CEOs who didn't know what was going on in their bond departments; bond traders who didn't understand their business or the instruments they were selling; rating agencies that manipulated data for their own benefit; and last but not least mortgage loan practices designed to enlist as many borrowers as possible, regardless of their creditworthiness.

Rube Goldberg by Any Other Name

The doomsday machine that Steve Eisman came to know was a nearly incomprehensible contraption fueled by greed, ignorance and fear. It was made up of newfangled financial instruments, including collateralized debt obligations (CDOs) and credit default swaps, designed by quants at firms like Goldman Sachs to attract triple-A ratings from the rating agencies. Insiders used complexity – and the appearance of complexity – to mask risk and maximize return.

> "From the social point of view the slow and possibly fraudulent unraveling of the multi-trillion-dollar US bond market was a catastrophe..."

These instruments were all derivative in nature; in effect, they were contracts between buyers and sellers based on mortgage-backed bonds' prices. They were structurally similar: A CDO was a structural replica of a credit default swap, which in turn was a structural replica of a subprime mortgage bond. The makeup of the original bonds included various levels or tranches, based on the quality of the loans in those tranches.

> "...From the hedge fund trading point of view it was the opportunity of a lifetime."

At peak performance, this doomsday machine was designed to bleed every drop of equity from the housing market, and, when that was gone, to create its own alternative fuel: synthetic CDOs. This soulless machine defied regulation, understanding and humanity itself. In the end, in its weird glory, it fulfilled its purpose: It enabled people to undermine or circumvent the financial system, see the opportunities in calamity and bet on that outcome. Some participants came to regard disaster, or some measure of disaster, as a good thing, at least for them.

The Benefits of Being Odd

Dr. Michael Burry, a physician turned scholar of subprime mortgages, was another investor who saw disaster rolling up on the horizon. He created Scion Capital, one of the most successful investment companies of all time. Burry himself was characteristic of this small group of people who recognized the workings of the doomsday machine: He was a loner, alienated and isolated, and a little odd, not the least because of his glass eye, which he came to think of as something that both narrowed his vision and broadened it. But his real oddity was that he was hypersensitive to unfairness and had an unwitting habit of being dead honest.

> "In the murky and curious period from early February to June 2007, the subprime mortgage market resembled a giant helium balloon, bound to earth by a dozen or so big Wall Street firms."

He was also incredibly focused and creative about finding investments. He once did a web search for the word "accepted" to find plea deals in court cases that might reveal undervalued firms. He found Avant – a software company accused of stealing a competitor's code. Its senior executives went to jail following a plea deal; the company paid huge fines and the stock dropped from $12 a share to $2. Burry bought the stock "all the way down," demanded changes from management and made a fortune when Avant later sold for $22 a share, a "classic Mike Burry trade."

> "By assuming that one pile of subprime mortgage loans wasn't exposed to the same forces as another...the engineers created the illusion of security."

But perhaps Burry's greatest triumph came in 2004, as the inherent dangers of subprime mortgages became clear – at least, to him. He saw an opportunity to make money from the coming crisis by buying credit default swaps on subprime mortgage bonds. In a typical credit default swap covering, say, corporate bonds, investors pay a premium over a period of years. If the bonds don't default, investors have lost their annual premiums. But if the bonds do default, investors earn the bonds' face value. Burry's swaps against the worst loans bundled into subprime mortgage bonds – loans almost certain to go bad – eventually paid off as defaults rose.

Gassing Up the Doomsday Machine

Steve Eisman's great adventures in the doomsday culture included attending an annual subprime mortgage conference with all the industry's top people at the Venetian hotel in Las Vegas in January 2007. The conference offered Eisman a series of "aha" moments. One such revelatory flash came at a dinner where Eisman sat next to Wing Chau, a CDO manager. Chau had made a fortune buying billions of dollars in triple-A-rated CDOs "that were backed by the triple-B tranche of a mortgage bond." Why did Chau, who knew the CDOs' true worth, buy them? He bought and kept buying them because he made his money off volume. His greatest hope was that the US economy would weaken and bring more CDOs his way.

> "...For Wall Street it was a machine that turned lead into gold."

The other revelation that smacked Eisman during the conference concerned the subculture within the rating agencies. Moody's, for one, had gone public some years earlier and was making mountains of money in commissions from the banks whose bonds it rated. At the conference, for the first time Eisman and his partners saw the kinds of people who worked for Moody's up close. They seemed completely unqualified for their work. They were not merely lackluster – much less the elites they needed to be to face the best and the brightest in the banks – they actually seemed to have no real concept of the risk they were supposed to manage. They stuck to a nine-to-five mentality, with a sense of naïveté mixed with disinterest, unaware of the disaster bearing down behind them.

> "There was effectively no way for an accountant assigned to audit a giant Wall Street firm to figure out whether it was making money or losing money."

Eisman left the conference at the beginning of that fateful year with the realization that Wall Street – particularly the bond market – was in much worse shape than he had previously imagined, that the people in daily charge of finance in America were not up to the task, and that greed and special interests had so bent the market that it was beyond control. It was finally doomed.

The Trader Who Would Be King

Besides pessimists like Eisman and Burry, others inside the financial system saw opportunities in buying insurance that covered subprime mortgage loans. Howie Hubler, a star Morgan Stanley bond trader – whose interpersonal skills were better-suited to the gridiron than to the boardroom – became a notable participant. In the middle of 2006, his trading desk was looking at profits of nearly $1 billion, up from $400 million in 2004.

> Michael Burry "attributed his unusual powers of concentration to his lack of interest in human interaction...he was able to argue that basically everything that happened was caused, one way or another, by his fake left eye."

With his success – Hubler himself earned $25 million in 2006 – he pushed Morgan Stanley to let him control and benefit from an ever-greater part of the pie. By the beginning of January 2007, Hubler had bought $16 billion in what appeared to be high-quality CDOs, but which were in fact much lower quality. When the crash came and the mortgage losses began in earnest, 40% of Hubler's CDOs became worthless. The securities had been inadequately stress-tested; the quants' consensus had been that losses would never top 6%.

> "We were positioned for Armageddon... but always at the back of our minds was, 'What if Armageddon doesn't happen?'" (Steve Eisman)

Hubler assumed all along that he would see some losses, but never on the scale that actually took place. The irony was that, in the end, Morgan Stanley tricked itself: It persuaded the rating agencies to view consumer loans as being like corporate loans. When the agencies looked past the distinction and gave highest marks to bonds backed by unpayable mortgages to people often at the bottom of the socioeconomic ladder, Hubler and others believed the sleight-of-hand. A top Morgan Stanley risk manager pointed out, "It's one thing to bet on red or black and know you are betting on red or black. It's another to bet on a form of red and not to know it." Yet, all the while, no one had a crisis of conscience. As one trader noted, "Nobody ever said, 'This is wrong'."

A Lack of Restraint

The insidious nature of the doomsday machine is in its tail. Disaster takes time to unfurl; mortgages take time to fail. First, the balloon payment comes; then foreclosure arrives, followed by bankruptcy and a forced sale. The impact on the bond is that of a slow disease. So when the crisis finally hit, with the gnashing of financial teeth, the passing of Bear Stearns, the bailout of the AIG – that was all a beginning, not an end.

> "Greed on Wall Street was a given – almost an obligation. The problem was the system of incentives that channeled the greed."

Eisman and Burry and a few others won big from their bets. Wing Chau's CDO management business crashed, but he personally made millions. Hubler set a record for money lost by a Wall Street trader, yet he, too, left the scene with millions. So did the CEOs in public institutions considered too big to fail, the top financial leaders whom authorities never held personally accountable for their mismanagement. This sends a lesson to those coming up that poor decisions bear no consequences.

> "There were more morons than crooks, but the crooks were higher up."

After the crisis subsided, instant revisionist history suggested that it had all been a "crisis in confidence" and that no bank had needed federal help. In a more realistic long view, the 2008 financial crisis grew out of 1980s policies and practices following the creation of early CDOs. It was a by-product of the trend among some companies to recast themselves from partnerships to public corporations, where financial consequences fall on stockholders, not on the decision makers inside the companies. These corporations no longer engendered bankers' and traders' former sense of personal responsibility. In a broader, more raw sense, the crisis was born of that loss and the power of greed, not just among bankers, but also among investors.

About the Author

Financial journalist **Michael Lewis** has written several bestsellers, including *Moneyball* and *Liar's Poker*. He also once sold bonds in the London office of Salomon

Brothers.