Michael Lewis. 2010. *The Big Short: Inside the Doomsday Machine*. New York: W.W. Norton Company. pp. 266. $27.95. ISBN 978-0-39-307223-5

The collapse of the subprime mortgage bond market and the resulting "Great Recession" produced tremendous outrage at the evident corruption and fraud, which has in turn fueled a cottage industry of elegant postmortems of the crisis.[1] Michael Lewis, one of the more entertaining observers of the financial world, has woven a story which captures the convoluted pathology of the U.S. investment banking system. Oklahomans concerned about the health of the financial industry are well advised to read *The Big Short* for an entertaining account of how a few traders spotted the bubble, and won enormous sums of money betting on when it would burst.

Lewis's first big book, *Liar's Poker* (1989) captured the manic quality of the "go go" Wall Street culture of the 1980's. In *The Big Short* (2010), he capitalized on relationships forged during his earlier career in the financial world to tell the story of the financial crisis from the perspective of a small group of money managers who had the foresight to see the subprime mortgage crisis coming, and who had the strength of will to resist the "follow-the-leader" Wall Street mentality that spawned the crisis. For seasoned financial observers, the mechanics of the story are familiar; as the "smart money" found themselves ensorcelled by the escalating complexity of the derivatives market, they

became ever more tolerant of the risks they were willing to take to justify their lavish compensation packages.

THE SHORT-SELLER AS HEROIC ACTOR

Lewis's narrative is driven by four constellations of characters. Greg Lippman occupied the role of the universally disliked and mistrusted Machiavellian insider, as he ruthlessly advocated shorting[2] the subprime mortgage bond in which his fellow bond traders at Deutsche Bank were heavily invested. Steve Eisman is cast as the "rebel bond trader," someone who, like Lewis, had become outraged at the casual way Wall Street fleeced middle-class investors; unlike Lewis, Eisman stayed in the game, and become something of an dark crusader against the fraudulent practices of the "originate and sell" mortgage companies like Aames and The Money Store. Some of the more entertaining passages of the book involve Eisman's sarcasm-laced denunciations of the mendacity and incompetence of Wall Street's leading figures. Eisman's putative subordinates, Vincent Daniel and Danny Moses, often found themselves watching in horrified fascination as Eisman ridiculed Wall Street's heavy hitters."'There is always the possibility of embarrassment,' Danny said. 'But it's like watching a car crash. You can't *not watch.*'" (p. 231).

Michael Burry, a neurosurgeon-turned-fledgling-hedge fund manager whose blogging on investing strategies brought him to the attention of some large-scale investors, is the beating heart of Lewis's narrative. Burry's extensive email communications with investors documented his growing fixation on the inner workings of the bond market; reading through "dozens of prospectuses... looking for the dodgiest pools of mortgages," Burry did the spadework that should have been a matter of due diligence for any financial analyst, but which was increasingly disdained by large investment banks and hedge funds (p. 50). Several of the more dramatic moments in Lewis's narrative involve Burry's (who readers would discover later in the book suffered from Asperger Syndrome) struggle to cajole his investors to stick with his long-term plan of shorting the subprime mortgage bond market, betting that an historic cascade of mortgage defaults would trigger a massive downturn in the market. The short-sighted and prone-to-panic description of Burry's investors is a pregnant commentary on the contemporary

investor.

The fourth set of characters – Charlie Ledley, Jamie Mai, and Ben Hocket of Cornwell Capital, derided by the Wall Street culture as "garage band hedge fund" (p. 167) – stand as a kind of comic relief. They were largely peripheral players who were deliberately playing a game of investing in relatively low-risk long shots; however, the more Ledley, Mai, and Hocket investigated the "collateralized debt obligations" that were proliferating throughout the subprime mortgage bond market, the more convinced they became that a huge collapse of the market was likely. As Lewis described the reasoning of Cornwell Capital's investment team,

> A CDO, in their view, was essentially just a pile a triple-B-rated mortgage bonds. Wall Street firms had conspired with the rating agencies to represent the pile as a diversified collection of assets, but anyone with eyes could see that if one triple-B subprime mortgage went bad, most would go bad, as they were all vulnerable to the same economic forces. Subprime mortgage loans in Florida would default for the same reasons, and at the same time, as subprime mortgage loans in California. And yet fully 80 percent of the CDO composed of nothing but triple-B bonds was rated higher than triple-B: triple-A, double-A, or A. To wipe out any triple-B bond – the ground floor of the building – all that was needed was a 7 percent loss in the underlying pool of human loans. That same 7 percent loss would thus wipe out, entirely, any CDO made up of triple-B bonds, no matter what rating was assigned it (p. 129).

Part of what lends sardonic charm to Lewis's narrative is his effort to imbue this cast of short-sellers with the virtues typical of classical protagonists. Often portrayed as the carrion-eaters of the financial world, and often blamed by beleaguered CEO's like Ken Lay and Richard Fuld as inspiring panicked flights from laboring corporations, Lewis describes these figures as clear-eyed crusaders speaking truth to power.

THE "BIG CON" FEEDS A "DOOMSDAY MACHINE"

Lewis's narrative is constructed around images and metaphors. The dominant narrative metaphor is "the Big Con." The short-sellers are cast as the "sharps," who saw a state of affairs ripe for exploitation,

but in order to short the market, they needed to undertake a complex set of maneuvers in order to make the "big score." In search of a lever with which to bet against the derivatives market, Michael Burry discovered one in 2004: a little-known device known as the credit default swap:

> In the beginning, credit default swaps had been a tool for hedging: Some bank had loaned more than they wanted to General Electric because GE asked for it, and they feared alienating a long-standing client; another bank changed its mind about the wisdom of lending to GE at all. Very quickly, however, the new derivatives became tools for speculation: A lot of people wanted to make bets on the likelihood of GE's defaulting. It struck Burry: Wall Street is bound to do the same thing with subprime mortgage bonds, too. Given what was happening in the real estate market – and given what subprime mortgage lenders were doing – a lot of smart people eventually were going to want to make side bets on subprime mortgage bonds. And the only way to do it would be to buy a credit default swap (p. 30).

Seeing an opportunity, and having identified a vehicle for speculating on the impending failure of the subprime mortgage bond market, one problem remained: finding a significant player willing to take the other side of the bet. Unsurprisingly, this small band of short-sellers had little trouble finding investment banks to take the other side of these bets.[3] The "mark," in this case, initially appeared to be the elite institutions of Wall Street. Lewis notes, however, that a small number of short-sellers like Burry sensed that these institutions were not on the other side of these bets, but were middlemen passing along the swaps to another, shadowy player. According to Lewis, "Only a triple-A-rated corporation could assume such risk, no money down, and no questions asked. Burry was right about this, too, but it would be three years before he knew it" (p. 68).

Ultimately, the mark would be revealed: American International Group. AIG Financial Products had the two qualities needed to act as a safe harbor for risky financial investments: first, AIG was not a bank, and hence was unregulated, and second, AIG's executives were willing to "bury exotic risks on its balance sheet" (p. 69). As Lewis put it, in "a matter of months, AIG FP, in effect, bought $50 billion in triple-B-rated

subprime mortgage bonds by insuring them against default" (p. 71). As to the obvious question of why any financial institution would take on such risk, the conventional wisdom was that these collateralized debt obligations were safe bets to take. The consensus among Wall Street investors was that these derivatives had been configured in such a way as to distribute the risks, and they persuaded themselves that the ratings agencies that a nation-wide collapse of the subprime mortgage bond market was prohibitively unlikely; hence, their willingness to take the other side of a series of speculative bets that would turn out spectacularly bad for those institutions that were long in the derivatives market. So collateralized debt obligations were hedged with credit default swaps – the trading of which exploded as institutions and investors began using them for speculative purposes – which enabled institutions to engage in increasingly risk-laden investment strategies without having to hold currency in reserve to meet their obligations. The likelihood of these investments drawing scrutiny was remote; the deregulatory spirit moved through the SEC and other regulatory bodies, and had even survived the political earthquake of the 2006 midterm elections that swept Democrats into power in Congress. The resulting leveraging of these major institutions would expose these institutions to existential risks; a state of affairs that many CEO's of the investment banking community would later confess that they did not understand.

Part of Lewis's skill lies in clearly describing how these complex derivatives were packaged:

> Having gathered 100 ground floors from 100 different subprime mortgage buildings (100 different triple-B-rated bonds), they persuaded the rating agencies that these weren't, as they might appear, all exactly the same things. They were another diversified portfolio of assets! This was absurd. The 100 buildings occupied the same floodplain; in the event of flood, the ground floors of all of them were equally exposed. But never mind: The rating agencies, who were paid fat fees by Goldman Sachs and other Wall Street firms for each deal they rated, pronounced 80 percent of the new tower of debt triple-A (p. 73).

The agents at Moody's and Standard and Poor do not come off as heroes in *The Big Short*. One As Wall Streeter sneered, "Guys who can't get a job on Wall Street get a job at Moody's" (p. 98).

Another important image – the game of "follow the leader" – captured the logic driving the conventional wisdom among the traders going long on subprime mortgage bonds. To illustrate, Lewis describes a dinner party in 2007 arranged by Greg Lippmann in which Lippmann very consciously seated a CDO manager named Wing Chau. According to Lewis, Chau, "spoke to Eisman in a tone of condescension. *I know better* (p. 143). Chau, who described himself as a "CDO manager," appeared to fundamentally misunderstand the nature of the risks he was taking on in purchasing CDO's; thinking that his role in the market was simply to maximize the cash for which his group was holding, he saw short-sellers like Eisman as helping to drive more business his way. As Eisman related, "He says to me, 'The more excited that you get that you're right, the more trades you'll do, and the more trades you do, the more product for me" (p. 143).

The conversation with Chau clarified Eisman's picture of the scope of problem in the financial sector; where most economists describe a variance between investment and intrinsic value as a "bubble," Eisman described the subprime mortgage bond market as a "doomsday machine." "They weren't satisfied getting lots of unqualified borrowers to borrow money and buy a house they couldn't afford"; instead, Eisman realized that the entire industry was complicit in multiplying the initial fraudulent loans hundreds of times over, creating the illusion of massive profits. The compulsion to join in the game was overpowering, drawing in the huge government corporations Freddie Mac and Fannie Mae, who had aggressively lobbied Congress to take on huge sectors of the prime mortgage bond market, and was rapidly moving into the subprime market as well.

THE DENOUEMENT: LETTING GO OF THE BALLOON

In the early months of 2007, subprime mortgages began defaulting at an escalating rate, which began attracting media attention, and Lewis's short-sellers watched with increasing impatience as the market failed to correct in the face of mounting evidence of a massive collapse. As Michael Burry struggled to persuade his investors that his seemingly arcane long-term bet would eventually pay off, and the other short-sellers were wondering who or what was propping up the market, Morgan Stanley's Howie Hubler purchased $16 billion "in triple-A-rated

CDOs, composed entirely of triple-B-rated subprime mortgage bonds, which became valueless when the underlying pools of subprime loans experienced losses of roughly 8 percent" (p. 206). The imagery of musical chairs captures the essence of what happened when the marketplace collectively realized that the repackaging of loans had not actually "converted lead into gold," as Lewis described the mortgage repackaging; in the game playing out in 2007, bond traders like Howie Hubler and AIF FP's Joe Cassano were left standing when the music stopped.

Eventually, all the major Wall Street firms came to recognize the extent of their exposure to the subprime mortgage loan market's cascading implosion, and between February and June of 2007 began to frantically attempt to hedge themselves away from the blast zone. Lewis uses a particularly effective metaphor to capture the collective circumstance in which Wall Street found itself:

> 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. Each firm held its rope; one by one, they realized that no matter how strongly they pulled, the balloon would eventually lift them off their feet. In June, one by one, they silently released their grip (p. 209).

Here again the imagery of a mindless, panic-stricken game of "follow-the-leader" captures the final months before tens of thousands of defaults tore through the veil of ignorance posing as conventional wisdom on Wall Street. Beginning with Deutsche Bank's $1.2 billion claim against Morgan Stanley in late July of 2007, people long in the market realized too late the extent of their exposure to the rapidly imploding subprime mortgage bond market.

THE FALLOUT: NOAH DURING THE FLOOD

Short-sellers in the immediate aftermath of the collapse of the subprime mortgage market had two fears. On the one hand, short-sellers were fearful that a massive government intervention would cause a rebound in the market; on the other hand, they were equally fearful that

the institutions with whom they had lodged their bets would collapse, wiping them out in the process. Fortunately, in the emerging panic the short-sellers had exactly what the big institutions long in the market desperately needed: credit default swaps. Holding a commodity for which most of Wall Street was in frantic demand, Charlie Ledley noted that it was "the first time we're seeing any prices that reflect anything close to like what they're really worth... We had positions that were being valued by Bear Sterns at six hundred grand that went to six million *the next day*" (p. 221).

Lewis combines two compelling images to capture the precarious situation in which his protagonists found themselves when the entire economy appeared on the verge of collapse:

> Greg Lippmann had imagined the subprime mortgage market as a great financial tug-of-war: on one side pulled the Wall Street machine making the loans, packaging the bonds, and repackaging the worst of the bonds into CDOs and then, when they ran out of loans, creating fake ones out of thin air; on the other side, his noble army of short sellers betting against the loans. The optimists versus the pessimists. The fantasists versus the realists. The sellers of credit default swaps versus the buyers. The wrong side versus the right. The metaphor was apt, up to a point: this point. Now the metaphor was two men in a boat, tied together by a rope, fighting to the death. One man kills the other, hurls his inert body over the side – only to discover himself being yanked over the side (pp. 226-227).

For Steve Eisman, the bets amounted to a series of insults aimed at arrogant institutions, but by 2008 he began to realize that the systemic risk might not just *hurt* the big investment firms like Bear Sterns and Lehman, but might also hurt the entire financial system, and could indeed cause its destruction. He noted to Lewis that his position was "sort of like the flood's about to happen and you're Noah. You're on the ark. Yeah, you're okay. But you are not happy looking out at the flood. That's not a *happy* moment for Noah" (p. 227).

By 2007, the guys at Cornwall Capital were convinced that a massive amount of fraud was being perpetrated within the subprime mortgage bond market, and were sufficiently concerned that they approached the Securities and Exchange Commission. Reading *The Big Short* leaves the reader convinced that SEC officials were generally clueless; in Lewis's narrative,

the SEC enforcement agents listened politely, but Ledley, Mai, and Hockett came to the conclusion that the agents could not wrap their minds around the complexity of the transactions taking place. As Ledley relates: "It was almost like a therapy session… We probably had this wild-eyed we've-been-up-for-three-days-straight look in our eyes… but they didn't know anything about CDO's, or asset-backed securities. We took them through our trade but I'm pretty sure they didn't understand it" (p. 166).

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Lewis is a talented storyteller, and he displays a real felicity for relating complex financial interactions using easily comprehended images and metaphors. The story that Lewis wanted to tell is undoubtedly a story that will resonate with a wide audience, and he is displays real skill in identifying and emphasizing character traits that connect his protagonists to the reader. For example, a writer with less aptitude might have struggled to render an affirmative portrait of the brash and opinionated Steve Eisman. Lewis succeeds by recognizing the Eisman's motivations, and encouraging the reader to look beneath Eisman's brusque exterior. In contrast, Lewis takes the opposite tack in his portrayal of Michael Burry, conveying real sensitivity to Burry's evident discomfort at human contact by holding back crucial information about Burry's Asperger's Syndrome until the latter half of the book.

However, Lewis's storytelling panache comes at a price. Certainly, Lewis is not the go-to guy for constructive depictions of Wall Street and its culture. Perhaps more importantly, readers seeking a careful analysis of the sequence of events that caused the subprime mortgage market to collapse, and a judicious apportionment of culpability to various suspects, will not find it in Lewis's narrative. For example, Lewis quickly loses interest in the regulators and the ratings agencies – major factors in the collapse – apparently because their role was so predictable. A nonfiction writer more interested in explanation than entertainment might have made different narrative decisions.

In conclusion, *The Big Short* is an entertaining and illuminating story about how a small band of investors saw the collapse coming, and whose foresight enabled them to survive and thrive despite Wall Street's near failure. Lewis's intuitive grasp of financial arcana, and his ability to discern the nuances of character and how they drive a

narrative marks him as the foremost chroniclers of the financial world. This book makes a valuable contribution to understanding what went wrong with Wall Street, and provides readers with a necessary counterpoise of skepticism to the cheerleaders at the business cable networks like CNBC and FOX Business.

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NOTES

[1] See, for example, Roger Lowenstein (2010) The End of Wall Street, New York, Penguin Press; Scott Patterson (2010), The Quants: How a New Breed of Math Whizzes Conquered Wall Street and Nearly Destroyed it, New York, Crown Business; Andrew Ross Sorkin (2009), Too Big toFail, New York, Viking Adult; Gregory Zuckerman (2009), The Greatest Trade Ever, New York, Broadway Business.

[2] For readers unversed in the vocabulary of investing, "going short" means that you are betting that a company or a sector of the industry will lose money. Conversely, "going long" means that an investor is betting that the stock they buy will increase in value.

[3] Later, Lewis would effectively use the imagery of another game– tug-of-war – to illustrate the interplay between short- and long-sellers.