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It's Not As Bad As You Think – It's Worse

I thought that – after six plus decades of living, two careers, and innumerable experiences in both the public and private sectors – my capacity for surprise at the depth of our moral and intellectual corruption had played itself out . . . and, then, I read Michael Lewis' new book, The Big Short: Inside the Doomsday Machine.

Lewis tells a story that we know all too well: The explosive growth and ultimate collapse of the subprime mortgage market. When I started the book, I was reasonably well informed about most of the movable parts that led to this historic economic debacle. I also had a sense of the greed, herd mentality, and short-term mindset that fueled it.

But Lewis provides a vivid and detailed roadmap for how it all worked and, equally, for the attitudes and mindsets that made this possible. Knowing in a general way that something is corrupt and unseemly is one thing. Getting a blow by blow description of the many, many taken for granted, wildly corrupt choices of so many, at so many different levels, is quite another.

One of the story's most powerful lesson is the sheer depth and virulence of the manipulation and self-aggrandizement that seemed to be the unquestioned mindset of virtually every participant. This was no benign financial bubble, where a product (dot com companies, silver, tulips in 17th century Holland) caught fire and had its price driven up by irrational optimism and the market's herd mentality.

In this case, really clever people used their enormous economic power and an unbounded lust for outsized profits, to create a highly suspect product – subprime mortgages – that they then transformed, through financial sleight-of-hand, into a blue chip seeming investments – triple A rate bonds – to be sold (and re-sold) to unsuspecting investors. The pay-off: Enormous fees for the originators of the mortgages and bonds, and multi-million dollar annual salaries and bonuses.

Lewis' story vividly illustrates the extent to which we have devolved into an atomistic, every person for himself society. The fate of their fellow citizens, the financial system, the country – all of these were someone else's problem. Indeed, even Lewis' "heroes" – a handful of people who saw what was coming – were focused, not on its social consequences, but on how to "short" this ill conceived market in order to make their own financial killing (hence, the book's title).

One aspect of Lewis' narrative that graphically illustrates this larger pattern of pervasive, systemically engrained corruption involves the role of the rating agencies – Moody's, Standard and Poor's, and Fitch. These companies provide risk assessing "grades" for bonds and other financial products. And their importance is unquestioned. Indeed, many investors – pension funds for example – are limited by law or internal guidelines to the "safest," Triple A rated investments.

One glaring problem with the system – one that no one hides – is the fact that the investment banks pay the rating agencies to rate their bonds. A reasonably intelligent investor would, you would think, be concerned that the agencies might go easy on the people who pay their bills. But as Lewis explains, the structural problems go much deeper. And this is where his story – here and elsewhere – becomes revelatory.

In many respects, the mistakes of the rating agencies and banks were identical. Wanting to flog the money machine – rather than slow it down – no one, seemingly, thought to systematically examine the underlying mortgages. Instead, the prevailing belief was that the bonds' diversity (mortgages drawn from all over the country), an ever-rising housing market, and other macro factors ensured their safety.

But because their sole rationale is to assess risk, you would think the rating agencies would have gone farther. And they did have "secret" formulas for assessing each offering's risk. But, as Lewis points out, rating agencies are populated with people who can't get jobs at Goldman Sachs and the other, sexier banks and hedge funds; people who, in terms of intelligence and drive, are typically overmatched. So crafted by relative lightweights – whose dedication was already compromised by the firm's financial self-interest – these formulas were full of holes.

And the investment banks systematically gamed the formulas – figuring out their weaknesses and exploiting them so that lousy products could still get a Triple A rating. In other words, bald cheating was routine and, indeed, was seen as smart, aggressive business – never mind that the junk that slipped through the system was sold to their customers who, you would think, were owed at least some duty of loyalty and fair dealing.

To illustrate how this gaming process worked, Lewis describes one aspect of the rating agency's formula: Their use of FICO scores to measure the credit worthiness of the borrowers who held the underlying mortgages. To earn a Triple A rating, the FICO score of the borrowers had to average out to at least 515.

Figuring this out, the investment bankers quickly realized that no distinction was being made between a "thick" FICO score – based on years of credit history – and a "thin" one. So, they would bring the overall average up by finding borrowers with high FICO scores but no reliable credit history – a person, for example, who once got a credit card, paid the bill, and never bought on credit again. And, rather that craft a portfolio of 515s, they further gamed the system by balancing the 400s (almost certain to default) with an equal number of 650s – thin or otherwise.

This cynical manipulation of the rating agencies – and, in turn, the purchasers who relied upon them – is just one of many stories that Lewis tells. We also learn about CEOs who didn't understand the markets their most profitable products were traded in; reckless and sociopathic traders who were given multi-million dollar bonuses; and a system where virtually every major player's reflexive response to the market's looming collapse was to hide the truth as long possible – so they could sell as many of their bad investments to others including, with no apparent compunction, their own customers.

In short we are given an in-depth X-ray into a system where lying is routine, loyalty nonexistent, and profits the only measure of success. And, the tepid reforms that have been passed in the aftermath of the market's meltdown have done almost nothing to alter this culture.

Lewis' story, by driving home the depth and pervasiveness of these behaviors, reminds us that reform efforts are far more challenging, today, than they were even 40 years ago. When a behavior becomes the norm, we lose our ability to view it as dysfunctional. That is why entire populations can embrace fascism (as in Germany and Italy), genocide (as in Rwanda or the Balkans), or senseless wars.

My sense is that we have reached that point in business. Many smaller businesses continue to operate in the old fashioned way – offering good products at a fair price; treating employees and others with some modicum of respect. But as you move up the pyramid in terms of size, the qualities that Lewis describes are, increasingly, the unquestioned norm. We live, after all, in a world where Donald Trump is celebrated on a major TV network even as he sells his name to unscrupulous developers and a bogus university. So one very serious challenge we face is to remold our collective consciousness so that, once again, fraud, recklessness, negligence, self-dealing, price gouging, and so on are viewed as disreputable – and not as business as usual.

Lewis' narrative is also a dramatic reminder that, as ordinary citizens, there is just so much we don't know. And, being reminded of that fact, another important take away is the huge price we pay when our leaders temporize in their critiques – as they habitually do – when it is not politically expedient.

When Bush invaded Iraq, virtually every political leader went along with it because, given the country's prevailing mood, the smart move was to stay silent until public opinion turned against the war. In that case, this cautious approach was relatively harmless: The issues were clear and the arguments against, readily available.

The subprime mortgage crisis, however, stands in stark contrast to Iraq. As Lewis' detailed accounting vividly demonstrates, we ordinary citizens had virtually no ability to understand the crisis as it unfolded or, even now, after the fact. Thus, our willingness to tolerate endemically cautious, politically driven leaders – leaders who refuse to lead – has had devastating consequences. We are, and continue to be, defenseless before the most devastating economic crisis of our lives. Given the unavoidable – and increasing – complexity of the world in which we live, our current situation demands leaders who actively identify and explain problems, and speak more aggressively and fearlessly to power.

The single mindedness with which the participants, including virtually every major bank and investment banking firm, pursued their greed driven goals is truly remarkable. Wholly focused on making a lot of money, fast, the social consequences of their choices was a complete nonfactor. So too were its effects on the financial industry and the companies for which they worked.

Faced with the most serious economic crisis of our life time, we were With no ability to understand what was happening, as it unfolded, we . So, in effect, we were defenseless. Having only the dimmest awareness of what was occurring, we paid a huge and stunningly lacking in leaders to point the way.

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One particularly discouraging

Here are some of the more striking aspects of the story, as Lewis tells it. To begin with, subprime mortgages were not just a lucky accident that the Wall Street firms then swooped in to exploit. To the contrary, these firms want crap mortgages. Why?

– the bonds and collateralized debt obligations (CDOs) created, packaged, and sold by the largest investment banking firms; the mortgage originators who supplied the underlying product; the pension plans and hedge funds that bought them; the rating agencies that greased the wheels for all of this by giving these bonds and CDOs at triple A rating.