Chapter One

A Secret Origin Story

Eisman entered finance about the time I exited it. He'd grown up in New York City, gone to yeshiva schools, graduated from the University of Pennsylvania magna cum laude, and then with honors from Harvard Law School. In 1991 he was a thirty-year-old corporate lawyer wondering why he ever thought he'd enjoy being a lawyer. "I hated it," he says. "I hated being a lawyer. My parents worked as brokers at Oppenheimer securities. They managed to finagle me a job. It's not pretty but that's what happened."

Oppenheimer was among the last of the old-fashioned Wall Street partnerships and survived on the scraps left behind by Goldman Sachs and Morgan Stanley. It felt less like a corporation than a family business. Lillian and Elliot Eisman had been giving financial advice to individual investors on behalf of Oppenheimer since the early 1960s. (Lillian had created their brokerage business inside of Oppenheimer, and Elliot, who had started out as a criminal attorney, had joined her after being spooked once too often by midlevel Mafia clients.) Beloved and respected by colleagues and clients alike, they could hire whomever they pleased. Before rescuing their son from his legal career they'd installed his old nanny on the Oppenheimer trading floor. On his way to reporting to his mother and father, Eisman passed the woman who had once changed his diapers. Oppenheimer had a nepotism rule, however; if Lillian and Elliot wanted to hire their son, they had to pay his salary for the first year, while others determined if he was worth paying at all.

Eisman's parents, old-fashioned value investors at heart, had always told him that the best way to learn about Wall Street was to work as an equity analyst. He started in equity analysis, working for the people who shaped public opinion about public companies. Oppenheimer employed twenty-five or so analysts, most of whose analysis went ignored by the rest of Wall Street. "The only way to get paid as an analyst at Oppenheimer was being right and making enough noise about it that people noticed it," says Alice Schroeder, who covered insurance companies for Oppenheimer, moved to Morgan Stanley, and eventually wound up being Warren Buffett's official biographer. She added, "There was a counterculture element to Oppenheimer. The people at the big firms were all being paid to be consensus." Eisman turned out to have a special talent

for making noise and breaking with consensus opinion. He started as a junior equity analyst, a helpmate, not expected to offer his own opinions. That changed in December 1991, less than a year into the new job. A subprime mortgage lender called Aames Financial went public, and no one at Oppenheimer particularly cared to express an opinion about it. One of Oppenheimer's bankers, who hoped to be hired by Aames, stomped around the research department looking for anyone who knew anything about the mortgage business. "I'm a junior analyst and I'm just trying to figure out which end is up," says Eisman, "but I told him that as a lawyer I'd worked on a deal for The Money Store." He was promptly appointed the lead analyst for Aames Financial. "What I didn't tell him was that my job had been to proofread the documents and that I hadn't understood a word of the fucking things."

Aames Financial, like The Money Store, belonged to a new category of firms extending loans to cash-strapped Americans, known euphemistically as "specialty finance." The category did not include Goldman Sachs or J.P. Morgan but did include many little-known companies involved one way or another in the early 1990s boom in subprime mortgage lending. Aames was the first subprime mortgage lender to go public. The second company for which Eisman was given sole responsibility was called Lomas Financial Corp. Lomas had just emerged from bankruptcy. "I put a sell rating on the thing because it was a piece of shit. I didn't know that you weren't supposed to put sell ratings on companies. I thought there were three boxes—buy, hold, sell—and you could pick the one you thought you should." He was pressured to be a bit more upbeat, but upbeat did not come naturally to Steve Eisman. He could fake upbeat, and sometimes did, but he was happier not bothering. "I could hear him shouting into his phone from down the hall," says a former colleague. "Joyfully engaged in bashing the stocks of the companies he covered. Whatever he's thinking, it comes out of his mouth." Eisman stuck to his sell rating on Lomas Financial, even after the Lomas Financial Corporation announced that investors needn't worry about its financial condition, as it had hedged its market risk. "The single greatest line I ever wrote as an analyst," says Eisman, "was after Lomas said they were hedged." He recited the line from memory: "'The Lomas Financial Corporation is a perfectly hedged financial institution: it loses money in every conceivable interest rate environment.' I enjoyed writing that sentence more than any sentence I ever wrote." A few months after he published that line, the Lomas Financial Corporation returned to bankruptcy.

Eisman quickly established himself as one of the few analysts at Oppenheimer whose opinions might stir the markets. "It was like going back to school for me," he said. "I would learn about an industry and I would go and write a paper about it." Wall Street people came to view him as a genuine character. He dressed half-fastidiously, as if someone had gone to great trouble to buy him nice new clothes but not told him exactly how they should be worn. His short-cropped blond hair looked as if he had cut it himself. The focal point of his soft, expressive, not unkind face was his mouth, mainly because it was usually at least half open, even while he ate. It was as if he feared that he might not be able to express whatever thought had just flitted through his mind quickly enough before the next one came, and so kept the channel perpetually clear. His other features all arranged themselves, almost dutifully, around the incipient thought. It was the opposite of a poker

face.

In his dealings with the outside world, a pattern emerged. The growing number of people who worked for Steve Eisman loved him, or were at least amused by him, and appreciated his willingness and ability to part with both his money and his knowledge. “He’s a born teacher,” says one woman who worked for him. “And he’s fiercely protective of women.” He identified with the little guy and the underdog without ever exactly being one himself. Important men who might have expected from Eisman some sign of deference or respect, on the other hand, often came away from encounters with him shocked and outraged. “A lot of people don’t get Steve,” Meredith Whitney had told me, “but the people who get him love him.” One of the people who didn’t get Steve was the head of a large U.S. brokerage firm, who listened to Eisman explain in front of several dozen investors at lunch why he, the brokerage firm head, didn’t understand his own business, then watched him leave in the middle of the lunch and never return. (“I had to go to the bathroom,” says Eisman. “I don’t know why I never went back.”) After the lunch, the guy had announced he’d never again agree to enter any room with Steve Eisman in it. The president of a large Japanese real estate firm was another. He’d sent Eisman his company’s financial statements and then followed, with an interpreter, to solicit Eisman’s investment. “You don’t even own stock in your company,” said Eisman, after the typically elaborate Japanese businessman introductions. The interpreter conferred with the CEO.

“In Japan it is not customary for management to own stock,” he said at length.

Eisman noted that the guy’s financial statements didn’t actually disclose any of the really important details about the guy’s company; but, rather than simply say that, he lifted the statement in the air, as if disposing of a turd. “This . . . this is toilet paper,” he said. “Translate that.”

“The Japanese guy takes off his glasses,” recalled a witness to the strange encounter. “His lips are quavering. World War Three is about to break out. ‘Toy-lay paper? Toy-lay paper?’”

A hedge fund manager who counted Eisman as a friend set out to explain him to me but quit a minute into it—after he’d described Eisman exposing various bigwigs as either liars or idiots—and started to laugh. “He’s sort of a prick in a way, but he’s smart and honest and fearless.”

“Even on Wall Street people think he’s rude and obnoxious and aggressive,” says Eisman’s wife, Valerie Feigen, who worked at J.P. Morgan before quitting to open the women’s clothing store Edit New York, and to raise their children. “He has no interest in manners. Believe me, I’ve tried and I’ve tried and I’ve tried.” After she’d brought him home for the first time, her mother had said, “Well, we can’t use him but we can definitely auction him off at UJA.”[1] Eisman had what amounted to a talent for offending people. “He’s not tactically rude,” his wife explains. “He’s sincerely rude. He knows everyone thinks of him as a character but he doesn’t think of himself that way. Steven lives inside his head.”

When asked about the pattern of upset he leaves in his wake, Eisman simply looks puzzled,

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[1] United Jewish Appeal.

even a bit wounded. “I forget myself sometimes,” he says with a shrug.

Here was the first of many theories about Eisman: He was simply so much more interested in whatever was rattling around his brain than he was in whoever happened to be standing in front of him that the one overwhelmed the other. This theory struck others who knew Eisman well as incomplete. His mother, Lillian, offered a second theory. “Steven actually has two personalities,” she said carefully. One was that of the boy to whom she had given the brand-new bicycle he so desperately craved, only to have him pedal it into Central Park, lend it to a kid he’d never met, and watch it vanish into the distance. The other was that of the young man who set out to study the Talmud, not because he had the slightest interest in God but because he was curious about its internal contradictions. His mother had been appointed chairman of the Board of Jewish Education in New York City, and Eisman was combing the Talmud for inconsistencies. “Who else studies Talmud so that they can find the mistakes?” asks his mother. Later, after Eisman became seriously rich and had to think about how to give money away, he landed on an organization called Footsteps, devoted to helping Hasidic Jews flee their religion. He couldn’t even give away his money without picking a fight.

By pretty much every account, Eisman was a curious character. And he’d walked onto Wall Street at the very beginning of a curious phase. The creation of the mortgage bond market, a decade earlier, had extended Wall Street into a place it had never before been: the debts of ordinary Americans. At first the new bond market machine concerned itself with the more solvent half of the American population. Now, with the extension of the mortgage bond market into the affairs of less creditworthy Americans, it found its fuel in the debts of the less solvent half.

The mortgage bond was different in important ways from old--fashioned corporate and government bonds. A mortgage bond wasn’t a single giant loan for an explicit fixed term. A mortgage bond was a claim on the cash flows from a pool of thousands of individual home mortgages. These cash flows were always problematic, as the borrowers had the right to pay off any time they pleased. This was the single biggest reason that bond investors initially had been reluctant to invest in home mortgage loans: Mortgage borrowers typically repaid their loans only when interest rates fell, and they could refinance more cheaply, leaving the owner of a mortgage bond holding a pile of cash, to invest at lower interest rates. The investor in home loans didn’t know how long his investment would last, only that he would get his money back when he least wanted it. To limit this uncertainty, the people I’d worked with at Salomon Brothers, who created the mortgage bond market, had come up with a clever solution. They took giant pools of home loans and carved up the payments made by homeowners into pieces, called tranches. The buyer of the first tranche was like the owner of the ground floor in a flood: He got hit with the first wave of mortgage prepayments. In exchange, he received a higher interest rate. The buyer of the second tranche—the second story of the skyscraper—took the next wave of prepayments and in exchange received the second highest interest rate, and so on. The investor in the top floor of the building received the lowest rate of interest but had the greatest assurance that his investment wouldn’t end before he wanted it to.

The big fear of the 1980s mortgage bond investor was that he would be repaid too quickly, not

that he would fail to be repaid at all. The pool of loans underlying the mortgage bond conformed to the standards, in their size and the credit quality of the borrowers, set by one of several government agencies: Freddie Mac, Fannie Mae, and Ginnie Mae. The loans carried, in effect, government guarantees; if the homeowners defaulted, the government paid off their debts. When Steve Eisman stumbled into this new, rapidly growing industry of specialty finance, the mortgage bond was about to be put to a new use: making loans that did not qualify for government guarantees. The purpose was to extend credit to less and less creditworthy homeowners, not so that they might buy a house but so that they could cash out whatever equity they had in the house they already owned.

The mortgage bonds created from subprime home loans extended the logic invented to address the problem of early repayment to cope with the problem of no repayment at all. The investor in the first floor, or tranche, would be exposed not to prepayments but to actual losses. He took the first losses until his investment was entirely wiped out, whereupon the losses hit the guy on the second floor. And so on.

In the early 1990s, just a pair of Wall Street analysts devoted their careers to understanding the effects of extending credit into places where that sun didn't often shine. Steve Eisman was one; the other was Sy Jacobs. Jacobs had gone through the same Salomon Brothers training program that I had, and now worked for a small investment bank called Alex Brown. "I sat through the Salomon training program and got to hear what this great new securitization model Lewie Ranieri was creating was going to do," he recalls. (Ranieri was the closest thing the mortgage bond market had to a founding father.) The implications of turning home mortgages into bonds were mind-bogglingly vast. One man's liability had always been another man's asset, but now more and more of the liabilities could be turned into bits of paper that you could sell to anyone. In short order, the Salomon Brothers trading floor gave birth to small markets in bonds funded by all sorts of strange stuff: credit card receivables, aircraft leases, auto loans, health club dues. To invent a new market was only a matter of finding a new asset to hock. The most obvious untapped asset in America was still the home. People with first mortgages had vast amounts of equity locked up in their houses; why shouldn't this untapped equity, too, be securitized? "The thinking in subprime," says Jacobs, "was there was this social stigma to being a second mortgage borrower and there really shouldn't be. If your credit rating was a little worse, you paid a lot more—and a lot more than you really should. If we can mass market the bonds, we can drive down the cost to borrowers. They can replace high interest rate credit card debt with lower interest rate mortgage debt. And it will become a self-fulfilling prophecy."

The growing interface between high finance and lower-middle-class America was assumed to be good for lower-middle-class America. This new efficiency in the capital markets would allow lower-middle-class Americans to pay lower and lower interest rates on their debts. In the early 1990s, the first subprime mortgage lenders—The Money Store, Greentree, Aames—sold shares to the public, so that they might grow faster. By the mid-1990s, dozens of small consumer lending companies were coming to market each year. The subprime lending industry was fragmented. Because the lenders sold many—though not all—of the loans they made to other investors, in the

form of mortgage bonds, the industry was also fraught with moral hazard. “It was a fast-buck business,” says Jacobs. “Any business where you can sell a product and make money without having to worry how the product performs is going to attract sleazy people. That was the seamy underbelly of the good idea. Eisman and I both believed in the big idea and we both met some really sleazy characters. That was our job: to figure out which of the characters were the right ones to pull off the big idea.”

Subprime mortgage lending was still a trivial fraction of the U.S. credit markets—a few tens of billions in loans each year—but its existence made sense, even to Steve Eisman. “I thought it was partly a response to growing income inequality,” he said. “The distribution of income in this country was skewed and becoming more skewed, and the result was that you have more subprime customers.” Of course, Eisman was paid to see the sense in subprime lending: Oppenheimer quickly became one of the leading bankers to the new industry, in no small part because Eisman was one of its leading proponents. “I took a lot of subprime companies public,” says Eisman. “And the story they liked to tell was that ‘we’re helping the consumer. Because we’re taking him out of his high interest rate credit card debt and putting him into lower interest rate mortgage debt.’ And I believed that story.” Then something changed.

Vincent Daniel had grown up in Queens, without any of the perks Steve Eisman took for granted. And yet if you met them you might guess that it was Vinny who had grown up in high style on Park Avenue and Eisman who had been raised in the small duplex on Eighty-second Avenue. Eisman was brazen and grandiose and focused on the big kill. Vinny was careful and wary and interested in details. He was young and fit, with thick, dark hair and handsome features, but his appearance was overshadowed by his concerned expression—mouth ever poised to frown, eyebrows ever ready to rise. He had little to lose but still seemed perpetually worried that something important was about to be taken from him. His father had been murdered when he was a small boy—though no one ever talked about that—and his mother had found a job as a bookkeeper at a commodities trading firm. She’d raised Vinny and his brother alone. Maybe it was Queens, maybe it was what had happened to his father, or maybe it was just the way Vincent Daniel was wired, but he viewed his fellow man with the most intense suspicion. It was with the awe of a champion speaking of an even greater champion that Steve Eisman said, “Vinny is *dark.*”

Eisman was an upper-middle-class kid who had been faintly surprised when he wound up at Penn instead of Yale. Vinny was a lower-middle-class kid whose mother was proud of him for getting into any college at all and prouder still when, in 1994, after Vinny graduated from SUNY–Binghamton, he’d gotten himself hired in Manhattan by Arthur Andersen, the accounting firm that would be destroyed a few years later, in the Enron scandal. “Growing up in Queens, you very quickly figure out where the money is,” said Vinny. “It’s in Manhattan.” His first assignment in Manhattan, as a junior accountant, was to audit Salomon Brothers. He was instantly struck by the opacity of an investment bank’s books. None of his fellow accountants was

able to explain why the traders were doing what they were doing. “I didn’t know what I was doing,” said Vinny. “But the scary thing was, my managers didn’t know anything either. I asked these basic questions—like, Why do they own this mortgage bond? Are they just betting on it, or is it part of some larger strategy? I thought I needed to know. It’s really difficult to audit a company if you can’t connect the dots.”

He concluded that 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. They were giant black boxes, whose hidden gears were in constant motion. Several months into the audit, Vinny’s manager grew tired of his questions. “He couldn’t explain it to me. He said, ‘Vinny, it’s not your job. I hired you to do XYZ, do XYZ and shut your mouth.’ I walked out of his office and said, ‘I gotta get out of here.’”

Vinny went looking for another job. An old school friend of his worked at a place called Oppenheimer and Co. and was making good money. He handed Vinny’s resume in to human resources, and it made its way to Steve Eisman, who turned out to be looking for someone to help him parse the increasingly arcane accounting used by subprime mortgage originators. “I can’t add,” says Eisman. “I think in stories. I need help with numbers.” Vinny heard that Eisman could be difficult and was surprised that, when they met, Eisman seemed interested only in whether they’d be able to get along. “He seemed to be just looking for a good egg,” says Vinny. They’d met twice when Eisman phoned him out of the blue. Vinny assumed he was about to be offered a job, but soon after they started to talk, Eisman received an emergency call on the other line and put Vinny on hold. Vinny sat waiting for fifteen minutes in silence, but Eisman never came back on the line.

Two months later, Eisman called him back. When could Vinny start?

Eisman didn’t particularly recall why he had put Vinny on hold and never picked up again, any more than he recalled why he had gone to the bathroom in the middle of lunch with a big-time CEO and never returned. Vinny soon found his own explanation: When he’d picked up the other line, Eisman had been informed that his first child, a newborn son named Max, had died. Valerie, sick with the flu, had been awakened by a night nurse, who informed her that she, the night nurse, had rolled on top of the baby in her sleep and smothered him. A decade later, the people closest to Eisman would describe this as an event that changed his relationship to the world around him. “Steven always thought he had an angel on his shoulder,” said Valerie. “Nothing bad ever happened to Steven. He was protected and he was safe. After Max, the angel on his shoulder was done. Anything can happen to anyone at any time.” From that moment, she noticed many changes in her husband, large and small, and Eisman did not disagree. “From the point of view of the history of the universe, Max’s death was not a big deal,” said Eisman. “It was just my big deal.”

At any rate, Vinny and Eisman never talked about what had happened. All Vinny knew was that the Eisman he went to work for was obviously not quite the same Eisman he’d met several months earlier. The Eisman Vinny had interviewed with was, by the standards of Wall Street analysts, honest. He was not completely uncooperative. Oppenheimer was among the leading bankers to the subprime mortgage industry. They never would have been given the banking

business if Eisman, their noisiest analyst, had not been willing to say nice things about them. Much as he enjoyed bashing the less viable companies, he accepted that the subprime lending industry was a useful addition to the U.S. economy. His willingness to be rude about a few of these subprime originators was, in a way, useful. It lent credibility to his recommendations of the others.

Eisman was now about to become noticeably more negatively disposed, in ways that, from the point of view of his employer, were financially counterproductive. "It was like he'd smelled something," said Vinny. "And he needed my help figuring out what it was he'd smelled." Eisman wanted to write a report that more or less damned the entire industry, but he needed to be more careful than usual. "You can be positive and wrong on the sell side," says Vinny. "But if you're negative and wrong you get fired." Ammunition to cause trouble had just arrived a few months earlier from Moody's: The rating agency now possessed, and offered for sale, all sorts of new information about subprime mortgage loans. While the Moody's database did not allow you to examine individual loans, it offered a general picture of the pools of loans underlying individual mortgage bonds: how many were floating-rate, how many of the houses borrowed against were owner-occupied. Most importantly: how many were delinquent. "Here's this database," Eisman said simply. "Go into that room. Don't come out until you've figured out what it means." Vinny had the feeling Eisman already knew what it meant.

Vinny was otherwise on his own. "I'm twenty-six years old," he says, "and I haven't really understood what mortgage-backed securities really are." Eisman didn't know anything about them either—he was a stock market guy, and Oppenheimer didn't even have a bond department. Vinny had to teach himself. When he was done, he had an explanation for the unpleasant odor wafting from the subprime mortgage industry that Eisman had detected. These companies disclosed their ever-growing earnings, but not much else. One of the many items they failed to disclose was the delinquency rate of the home loans they were making. When Eisman had bugged them for these, they'd pretended that the fact was irrelevant, as they had sold all the loans off to people who packaged them into mortgage bonds: The risk was no longer theirs. This was untrue. All retained some small fraction of the loans they originated, and the companies were allowed to book as profit the expected future value of those loans. The accounting rules allowed them to assume the loans would be repaid, and not prematurely. This assumption became the engine of their doom.

What first caught Vinny's eye were the high prepayments coming in from a sector called "manufactured housing." ("It sounds better than 'mobile homes.'") Mobile homes were different from the wheel-less kind: Their value dropped, like cars', the moment they left the store. The mobile home buyer, unlike the ordinary home buyer, couldn't expect to refinance in two years and take money out. *Why were they prepaying so fast?* Vinny asked himself. "It made no sense to me. Then I saw that the reason the prepayments were so high is that they were involuntary." "Involuntary prepayment" sounds better than "default." Mobile home buyers were defaulting on their loans, their mobile homes were being repossessed, and the people who had lent them money were receiving fractions of the original loans. "Eventually I saw that all the subprime sectors were

either being prepaid or going bad at an incredible rate," said Vinny. "I was just seeing stunningly high delinquency rates in these pools." The interest rate on the loans wasn't high enough to justify the risk of lending to this particular slice of the American population. It was as if the ordinary rules of finance had been suspended in response to a social problem. A thought crossed his mind: How do you make poor people feel wealthy when wages are stagnant? You give them cheap loans.

To sift every pool of subprime mortgage loans took him six months, but when he was done he came out of the room and gave Eisman the news. All these subprime lending companies were growing so rapidly, and using such goofy accounting, that they could mask the fact that they had no real earnings, just illusory, accounting-driven, ones. They had the essential feature of a Ponzi scheme: To maintain the fiction that they were profitable enterprises, they needed more and more capital to create more and more subprime loans. "I wasn't actually a hundred percent sure I was right," said Vinny, "but I go to Steve and say, 'This really doesn't look good.' That was all he needed to know. I think what he needed was evidence to downgrade the stock."

The report Eisman wrote trashed all of the subprime originators; one by one, he exposed the deceptions of a dozen companies. "Here is the difference," he said, "between the view of the world they are presenting to you and the actual numbers." The subprime companies did not appreciate his effort. "He created a shitstorm," said Vinny. "All these subprime companies were calling and hollering at him: *You're wrong. Your data's wrong*. And he just hollered back at them, 'It's YOUR fucking data!'" One of the reasons Eisman's report disturbed so many is that he'd failed to give the companies he'd insulted fair warning. He'd violated the Wall Street code. "Steve knew this was going to create a shitstorm," said Vinny. "And he wanted to create the shitstorm. And he didn't want to be talked out of it. And if he told them, he'd have had all these people trying to talk him out of it."

"We were never able to evaluate the loans before because we never had the data," said Eisman later. "My name was wedded to this industry. My entire reputation had been built on covering these stocks. If I was wrong, that would be the end of the career of Steve Eisman."

Eisman published his report in September 1997, in the middle of what appeared to be one of the greatest economic booms in U.S. history. Less than a year later, Russia defaulted and a hedge fund called Long-Term Capital Management went bankrupt. In the subsequent flight to safety, the early subprime lenders were denied capital and promptly went bankrupt en masse. Their failure was interpreted as an indictment of their accounting practices, which allowed them to record profits before they were realized. No one but Vinny, so far as Vinny could tell, ever really understood the crappiness of the loans they had made. "It made me feel good that there was such inefficiency to this market," he said. "Because if the market catches on to everything, I probably have the wrong job. You can't add anything by looking at this arcane stuff, so why bother? But I was the only guy I knew who was covering companies that were all going to go bust during the greatest economic boom we'll ever see in my lifetime. I saw how the sausage was made in the economy and it was really freaky."

That was the moment it first became clear that Eisman wasn't just a little cynical. He held a picture of the financial world in his head that was radically different from, and less flattering than, the financial world's self-portrait. A few years later, he quit his job and went to work for a giant hedge fund called Chilton Investment. He'd lost interest in telling other people where to put their money. He thought he might be able to remain interested if he managed money himself and bet on his own judgments. Having hired Eisman, Chilton Investment had second thoughts. "The whole thing about Steve," said a Chilton colleague, "was, 'Yeah, he's a really smart guy. But can he pick stocks?'" Chilton decided that he couldn't and relegated him to his old role of analyzing companies for the guy who actually made the investment decisions. Eisman hated it, but he did it, and in doing it he learned something that prepared him uniquely for the crisis that was about to occur. He learned what was really going on inside the market for consumer loans.

The year was now 2002. There were no public subprime lending companies left in America. There was, however, an ancient consumer lending giant called Household Finance Corporation. Created in the 1870s, it had long been a leader in the field. Eisman understood the company well, he thought, until he realized that he didn't. In early 2002 he got his hands on Household's new sales document offering home equity loans. The company's CEO, Bill Aldinger, had grown Household even as his competitors went bankrupt. Americans, digesting the Internet bust, seemed in no position to take on new debts, and yet Household was making loans at a faster pace than ever. A big source of its growth had been the second mortgage. The document offered a fifteen-year, fixed-rate loan, but it was bizarrely disguised as a thirty-year loan. It took the stream of payments the homeowner would make to Household over fifteen years, spread it hypothetically over thirty years, and asked: If you were making the same dollar payments over thirty years that you are in fact making over fifteen, what would your "effective rate" of interest be? It was a weird, dishonest sales pitch. The borrower was told he had an "effective interest rate of 7 percent" when he was in fact paying something like 12.5 percent. "It was blatant fraud," said Eisman. "They were tricking their customers."

It didn't take long for Eisman to find complaints from borrowers who had figured out what had just happened to them. He scoured small newspapers around the country. In the town of Bellingham, Washington—the last city of any size before you reach Canada—he found a reporter named John Stark, who wrote for the *Bellingham News*. Before Eisman called him out of the blue, Stark had written a small piece about four locals who thought they had been deceived by Household and found a plaintiff's attorney willing to sue the company and void the mortgage contracts. "I was skeptical at first," says Stark. "I thought, Here's another person who has borrowed too much money and hired a lawyer. I wasn't too sympathetic." When the piece was published, it drew a crowd: Hundreds of people in and around Bellingham had picked up the newspaper to discover that their 7 percent mortgage was in fact a 12.5 percent mortgage. "People were coming out of the woodwork," says Stark. "They were angry. A lot of them didn't realize what had happened to them."

Whatever Eisman was meant to be doing got pushed to one side. His job became a single-minded crusade against the Household Finance Corporation. He alerted newspaper reporters, he

called up magazine writers, he became friendly with the Association of Community Organizations for Reform Now (ACORN), which must be the first time a guy from a Wall Street hedge fund exhibited such interest in an organization devoted to guarding the interests of the poor. He repeatedly pestered the office of the attorney general of the state of Washington. He was incredulous to learn that the attorney general had investigated Household and then been prevented, *by a state judge*, from releasing the results of his investigation. Eisman obtained a copy; its contents confirmed his worst suspicions. "I would say to the guy in the attorney general's office, 'Why aren't you arresting people?' He'd say, 'They're a powerful company. If they're gone, who would make subprime loans in the state of Washington?' I said, 'Believe me, there will be a train full of people coming to lend money.'"

Really, it was a federal issue. Household was peddling these deceptive mortgages all over the country. Yet the federal government failed to act. Instead, at the end of 2002, Household settled a class action suit out of court and agreed to pay a $484 million fine distributed to twelve states. The following year it sold itself, and its giant portfolio of subprime loans, for $15.5 billion to the British financial conglomerate the HSBC Group.

Eisman was genuinely shocked. "It never entered my mind that this could possibly happen," he said. "This wasn't just another company—this was the biggest company by far making subprime loans. And it was engaged in just blatant fraud. They should have taken the CEO out and hung him up by his fucking testicles. Instead they sold the company and the CEO made a hundred million dollars. And I thought, *Whoa! That one didn't end the way it should have*." His pessimism toward high finance was becoming tinged with political ideas. "That's when I started to see the social implications," he said. "If you are going to start a regulatory regime from scratch, you'd design it to protect middle- and lower-middle-income people, because the opportunity for them to get ripped off was so high. Instead what we had was a regime where those were the people who were protected the least."

Eisman left work at noon every Wednesday so that he might be present at Midtown Comics when the new shipment of stories arrived. He knew more than any grown man should about the lives of various superheroes. He knew the Green Lantern oath by heart, for instance, and understood Batman's inner life better than the Caped Crusader himself. Before the death of his son, Eisman had read the adult versions of the comics he'd read as a child—*Spider-Man* was his favorite. Now he read only the darkest adult comics, and favored those that took familiar fairy tales and rearranged them without changing any of the facts, so that the story became less familiar, and something other than a fairy tale. "Telling a story that is consistent with everything that happened before," as he put it. "And yet the story is totally different. And it leads you to look at the earlier episodes differently." He preferred relations between Snow White and the dwarves to be a bit more fraught. Now a fairy tale was being reinvented before his eyes in the financial markets. "I started to look more closely at what a subprime mortgage loan was all about," he said. "A subprime auto loan is in some ways honest because it's at a fixed rate. They may be charging you high fees and ripping your heart out, but at least you know it. The subprime mortgage loan was a cheat. You're basically drawing someone in by telling them, 'You're going to pay off all

your other loans—your credit card debt, your auto loans—by taking this one loan. And look at the low rate!' But that low rate isn't the real rate. It's a teaser rate."

Obsessing over Household, he attended a lunch organized by a big Wall Street firm. The guest speaker was Herb Sandler, the CEO of a giant savings and loan called Golden West Financial Corporation. "Someone asked him if he believed in the free checking model," recalls Eisman. "And he said, 'Turn off your tape recorders.' Everyone turned off their tape recorders. And he explained that they avoided free checking because it was really a tax on poor people—in the form of fines for overdrawing their checking accounts. And that banks that used it were really just banking on being able to rip off poor people even more than they could if they charged them for their checks."

Eisman asked, "Are any regulators interested in this?"

"No," said Sandler.

"That's when I decided the system was really, 'Fuck the poor.'"

In his youth, Eisman had been a strident Republican. He joined right-wing organizations, voted for Reagan twice, and even loved Robert Bork. It wasn't until he got to Wall Street, oddly, that his politics drifted left. He attributed his first baby steps back to the middle of the political spectrum to the end of the cold war. "I wasn't as right-wing because there wasn't as much to be right-wing about." By the time Household's CEO, Bill Aldinger, collected his $100 million, Eisman was on his way to becoming the financial market's first socialist. "When you're a conservative Republican, you never think people are making money by ripping other people off," he said. His mind was now fully open to the possibility. "I now realized there was an entire industry, called consumer finance, that basically existed to rip people off."

Denied the chance to manage money by his hedge fund employer, he quit and tried to start his own hedge fund. An outfit called FrontPoint Partners, soon to be wholly owned by Morgan Stanley, housed a collection of hedge funds. In early 2004, Morgan Stanley agreed to let Eisman set up a fund that focused exclusively on financial companies: Wall Street banks, home builders, mortgage originators, companies with big financial services divisions—General Electric (GE), for instance—and anyone else who touched American finance. Morgan Stanley took a cut of the fees off the top and provided him with office space, furniture, and support staff. The only thing they didn't supply him with was money. Eisman was expected to drum that up on his own. He flew all over the world and eventually met with hundreds of big-time investors. "Basically we tried to raise money, and didn't really do it," he says. "Everyone said, 'It's a pleasure to meet you. Let's see how you do.'"

By the spring of 2004 he was in a state. He hadn't raised money; he didn't know that he would; he didn't even know if he could. He certainly didn't believe that the world was fair, or that things always worked out for the best, or that he enjoyed some special protection from life's accidents. He was waking up at four in the morning, drenched in sweat. He was also in therapy. He was still Eisman, however, and so it wasn't conventional therapy. "Work group," it was called. A handful

of professionals gathered with a trained psychotherapist to share their problems in a safe environment. Eisman would burst in late to these meetings, talk through whatever was bothering him, and then rush off before the others had a chance to tell him about *their* problems. After he'd done this a couple of times, the therapist said something to him about it, but he didn't appear to have heard her. So she took to calling Eisman's wife, whom she knew, to ask her to have a word with her husband. That didn't work either. "I always knew when he'd been to group," said Valerie, "because she'd call and say, 'He did it again!'"

Valerie was clearly weary of the rat race. She told Eisman that if this latest Wall Street venture didn't work out, they would leave New York for Rhode Island and open a bed-and-breakfast. Valerie had scouted places and spoke often about spending more time with the twins she'd given birth to, and even raising chickens. It was almost as hard for Eisman to imagine himself raising chickens as it was for people who knew him, but he'd agreed. "The idea of it was so unbelievably unappealing to him," says his wife, "that he started to work harder." Eisman traveled all over Europe and the United States searching for people willing to invest with him and found exactly one: an insurance company, which staked him to $50 million. It wasn't enough to create a sustainable equity fund, but it was a start.

Instead of money, Eisman attracted people, whose views of the world were as shaded as his own. Vinny, who had just coauthored a gloomy report called "A Home without Equity Is Just a Rental with Debt," came right away. Porter Collins, a two-time Olympic oarsman who had worked with Eisman at Chilton Investment and never really understood why the guy with the bright ideas wasn't given more authority, came along too. Danny Moses, who became Eisman's head trader, came third. Danny had worked as a salesman at Oppenheimer and Co. and had pungent memories of Eisman doing and saying all sorts of things that sell-side analysts seldom did. In the middle of one trading day, for instance, Eisman had walked to the podium at the center of the Oppenheimer trading floor, called for everyone's attention, announced that "the following eight stocks are going to zero," and then listed eight companies that indeed went bankrupt. Raised in Georgia, the son of a finance professor, Danny was less openly fatalistic than Vinny or Steve, but he nevertheless shared a general sense that bad things can and do happen, especially on Wall Street. When a Wall Street firm helped him to get into a trade that seemed perfect in every way, he asked the salesman, "I appreciate this, but I just want to know one thing: How are you going to fuck me?"

Heh-heh-heh, c'mon, we'd never do that, the trader started to say, but Danny, though perfectly polite, was insistent.

We both know that unadulterated good things like this trade don't just happen between little hedge funds and big Wall Street firms. I'll do it, but only after you explain to me how you are going to fuck me. And the salesman explained how he was going to fuck him. And Danny did the trade.

All of them enjoyed, immensely, the idea of running money with Steve Eisman. Working for Eisman, you never felt you were working *for* Eisman. He'd teach you but he wouldn't supervise you. Eisman also put a fine point on the absurdity they saw everywhere around them. "Steve's

fun to take to any Wall Street meeting," said Vinny. "Because he'll say 'explain that to me' thirty different times. Or 'could you explain that more, in English?' Because once you do that, there's a few things you learn. For a start, you figure out if they even know what they're talking about. And a lot of times they don't!"

By early 2005 Eisman's little group shared a sense that a great many people working on Wall Street couldn't possibly understand what they were doing. The subprime mortgage machine was up and running again, as if it had never broken down in the first place. If the first act of subprime lending had been freaky, this second act was terrifying. Thirty billion dollars was a big year for subprime lending in the mid-1990s. In 2000 there had been $130 billion in subprime mortgage lending, and 55 billion dollars' worth of those loans had been repackaged as mortgage bonds. In 2005 there would be $625 billion in subprime mortgage loans, $507 billion of which found its way into mortgage bonds. *Half a trillion dollars in subprime mortgage–backed bonds in a single year*. Subprime lending was booming even as interest rates were rising—which made no sense at all. Even more shocking was that the terms of the loans were changing, in ways that increased the likelihood they would go bad. Back in 1996, 65 percent of subprime loans had been fixed-rate, meaning that typical subprime borrowers might be getting screwed, but at least they knew for sure how much they owed each month until they paid off the loan. By 2005, 75 percent of subprime loans were some form of floating-rate, usually fixed for the first two years.

The original cast of subprime financiers had been sunk by the small fraction of the loans they made that they had kept on their books. The market might have learned a simple lesson: Don't make loans to people who can't repay them. Instead it learned a complicated one: You can keep on making these loans, just don't keep them on your books. Make the loans, then sell them off to the fixed income departments of big Wall Street investment banks, which will in turn package them into bonds and sell them to investors. Long Beach Savings was the first existing bank to adopt what was called the "originate and sell" model. This proved such a hit—Wall Street would buy your loans, even if you would not!—that a new company, called B&C mortgage, was founded to do nothing but originate and sell. Lehman Brothers thought that was such a great idea that they bought B&C mortgage. By early 2005 all the big Wall Street investment banks were deep into the subprime game. Bear Stearns, Merrill Lynch, Goldman Sachs, and Morgan Stanley all had what they termed "shelves" for their subprime wares, with strange names like HEAT and SAIL and GSAMP, that made it a bit more difficult for the general audience to see that these subprime bonds were being underwritten by Wall Street's biggest names.

Eisman and his team had a from-the-ground-up understanding of both the U.S. housing market and Wall Street. They knew most of the subprime lenders—the guys on the ground making the loans. Many were the very same characters who had created the late 1990s debacle. Eisman was predisposed to suspect the worst of whatever Goldman Sachs might be doing with the debts of lower-middle-class Americans. "You have to understand," he says. "I did subprime first. I lived with the worst first. These guys lied to infinity. What I learned from that experience was that Wall Street didn't give a shit what it sold." What he couldn't understand was who was buying the bonds from this second wave of subprime mortgage lending. "The very first day, we said,

‘There’s going to come a time when we’re going to make a fortune shorting this stuff. It’s going to blow up. We just don’t know how or when.’”

By “this stuff,” Eisman meant the stocks of companies involved in subprime lending. Stock prices could do all sorts of crazy things: He didn’t want to short them until the loans started going bad. To that end, Vinny kept a close eye on the behavior of the American subprime mortgage borrower. On the twenty-fifth of each month, the remittance reports arrived on his computer screen, and he scanned them for any upticks in delinquencies. “According to the things we were tracking,” says Vinny, “the credit quality was still good. At least until the second half of 2005.”

In the fog of the first eighteen months of running his own business, Eisman had an epiphany, an identifiable moment when he realized he’d been missing something obvious. Here he was, trying to figure out which stocks to pick, but the fate of the stocks depended increasingly on the bonds. As the subprime mortgage market grew, every financial company was, one way or another, exposed to it. “The fixed income world dwarfs the equity world,” he said. “The equity world is like a fucking zit compared to the bond market.” Just about every major Wall Street investment bank was effectively run by its bond departments. In most cases—Dick Fuld at Lehman Brothers, John Mack at Morgan Stanley, Jimmy Cayne at Bear Stearns—the CEO was a former bond guy. Ever since the 1980s, when the leading bond firm, Salomon Brothers, had made so much money that it looked as if it was in a different industry than the other firms, the bond market had been where the big money was made. “It was the golden rule,” said Eisman. “The people who have the gold make the rules.”

Most people didn’t understand how what amounted to a two-decade boom in the bond market had overwhelmed everything else. Eisman certainly hadn’t. Now he did. He needed to learn everything he could about the fixed income world. He had plans for the bond market. What he didn’t know was that the bond market also had plans for him. It was about to create an Eisman-shaped hole.