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FCIC memo of staff interview with James Surowiecki, The New Yorker

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Recommended Citation
Surowiecki, James; Mcwilllams, Bruce; Norman, Donna; and Paul, Adam, "FCIC memo of staff interview with James Surowiecki, The New Yorker" (2010). *YPFS Documents (Series 1)*. 6141.
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Memorandum for the Record

James Surowiecki (Sur- Wick—ee)

Columnist for *The New Yorker* magazine and author of *The Wisdom of Crowds*

Type: Telephone Interview

Date of Event: November 16, 2010 (10-11:15am)

Team Leader: Adam Paul

Location: FCIC, by telephone. FCIC participants used the small conference room

Participants –Non-Commission: James Surowiecki

Participants—Commission: Bruce McWilliams, Donna Norman, and Adam Paul

MFR Prepared: Adam Paul

Date of MFR: 2010-11-16

The following text is an edited version of notes taken during the interview. The text was revised using the tape of the interview. It is not a transcript but does accurately represent the speech of the interviewee.

Surowiecki is asked to agree on tape that he agrees to be recorded.

Could you please describe your professional background?

In the way of background, the FCIC was established by statute and signed into law by the President. It is bipartisan and consists of 10 commissioners. It is charged with examining the causes of the financial crisis and collapse or near collapse of major domestic financial institutions. The Commission is charged with composing a report of findings to the President and Congress by 15 December 2010.

Paul: Could you please start by giving us a bit of your professional background?

I am a business columnist for *The New Yorker*. I've been a business writer for over a decade and business writer since mid-90s. I've written at other publications but my *New Yorker* job has been the main one.

Paul: Let's start with the big question, what caused the financial crisis?

Not a single cause but a confluence a several really important trends.

If you needed one phrase to describe this crisis, I think that it was a housing bubble.

[3:15] core problem ultimately was that housing prices got way out of whack

Banks made the worst bet in history. Tends to be a bet by investors because of securitization. If borrower doesn't pay back then the house will worth something close to what its worth and they can resell it. The refinancing deals had prices that were nowhere close to that reality.

The role of securitization is very important. It's not something that I want to do away with. The farther those lenders got from borrowers; the investor is the real lender,

[5:20]

There was a relentless focus on short-term by Wall Street firms on compensation. A willingness to go along with the rid "I'll be gone; you'll be gone" and I think that had a major effect as well.

There is an obsession in the US with homeownership. It's a cultural thing and also a political thing. Tremendous emphasis on politicians on homeownership made people think it was always the right thing to do.

[7]

Pushed lots of people into homeownership

Paul: When did you see prices out of "whack?"

There are some that argue that it goes back to the late 1990s. The divergence in home prices from their historical trends. When I think about bubbles, a profound divergence from fundamental values. One way to think about that is rents.

One thing that becomes important in people's decision is that they can resell at a higher price somewhere down the road. If you look at 1990s there was speculation in stock market. Speculation in housing was really important in 2005 2006. I started to think about it in 2002 2003. The fact that San Fran held up as well as it did after the stock bubble.

At least in NYC you had a housing market that continued to rise.

[10]

I remember thinking about buying and I recall it was already too expensive

Paul: Did we learn the wrong lessons from the stock bubble?

[11:20]

There is a way retrospectively we give things a rosy glow. If you go back to 2000 or 2001, it felt worse. The recession likely had some impact on the election. The growth was weak but we did come out of it. It contributed to the great moderation. The stock bubble rise and fall was sharp but basic fundamentals were controllable.

The other things that I think about in that period, but have no answers for them, if we'd had no housing bubble what if we had tried to have a real regular economy. What would have picked up slack? The Internet bubble and its impact on stock market had massive effects on real economy. Job creation was off the charts—relative to post '73 period. That went away.

[14]

In that sense the housing bubble papered over problems that we didn't have solutions for at the time.

Homeowners, did they just not understand?

[15]

The system is set-up to encourage people to buy homes. Fannie Mae and Freddie Mac, although they kept denying that they had this federal guarantee behind them, everyone assumed what turned out to fail, which was that the government would not let them fail. That made it easy for people to buy. They had a major impact. I mean what does conforming mean? It's a loan that they will buy.

They got the support that everyone expected. They were not the engine of subprime lending. If you buy a home we give you a break. The federal government subsidizes homeownership. The Clinton and Bush administration trumpeted homeownership as a triumph.

There are deeper historical and culture roots about homeownership. If you compare us to Germany, not sure of rate, but say 40 percent, no one takes that as a sign that the German economy is weak. It's just that housing is not seen as the *sine qua non* for economic strength but in the US it.

On top of it you had a flood of money. You had a fantasy on the part of investors that securitization had distributed risk in such as way that they no longer needed to worry about the fact, you know, that people might not pay back their loans.

[17:20]

On the part of borrowers, it was a complicated thing. If you look at books like Gary Rivlin's *Broke USA* or *Monster* by Hudson-in many cases, in some cases, let's say a good number of cases people didn't understand what they were doing. They didn't understand how interest rates would reset. In other cases there was explicit fraud. On the part of borrowers there was a sense that buying a home was going to be a financial smart thing to do. There is an unfortunate intersection between what people thought and what people who wanted. Borrowing to buy a home can be useful. Leverage, well Wall Street banks made millions using leverage. What people didn't think very hard about was how the nature of mortgages had change and changed the calculus. On top of it and more importantly, this seems incredibly obvious, deciding if an investment is good or not depends upon the price at which you buy. So buying a house might make sense at X price but probably doesn't make any sense at 3X. That's what happens in bubbles—people become relatively indifferent to price.

[19:51]

One of the things people didn't really think about was and maybe that since it was not exploding until 04-05, was what home equity loans would do. When you look at how much was home equity or refinance. One of the things that is distinctive about this bubble is how much of it was driven by home equity or second mortgages. Also important was how much of that equity was taken out and used for spending. That really changes the economics of homeownership. One of the reasons that homes work is that they are forced savings. People have a hard time saving generally and a home is a way of forced saving. You pay your mortgage every month and are better at doing that than putting it in the bank. If you take a huge chunk of equity out, then the benefits of forced savings are gone. They thought that housing prices were going to keep going up.

Paul: How did crowds get it so wrong?

John Cassidy talks about that. (His blog for the New Yorker—Rational Irrationality). I think that crowds are periodically subject to these kinds of things. We know that bubbles are a reality of markets. We know that irrationality is part of human endeavor. There was some self-interest going to risk. I'm not as convinced that everyone was making individually rationally decisions. Even if you look at an individual level at the end of a bubble, they are not rational. Most people cannot get out in time and the like.

[24]

I think that the defining condition of a healthy market is diversity of opinion and there was very little of that. There was a conviction that was being drug home in myriad ways that buying a home was really the best thing to do.

As I think and if you were trying to quantify it would be small but important. One thing that is different about housing from say the stock market is that stocks you cannot bet against the housing market. There wasn't a way to short housing. There wasn't a way to register your opinion in an economic way.

[25]

You could sell your house but you couldn't do more than that. You couldn't really bet against it. It might have made people check their opinions. Instead, the market price was being set by people who all thought housing prices would rise.

Paul: were we not inventive enough?

After the disaster of the last decade, I hesitate to try to make the case for financial innovation but I am on the side of someone like Robert Shiller who argues that we need more fin innovation not less. Had we had tools that made it easier for people with contrary opinions to register in some way and put their money on the line that the effects might have been different? I don't think that it would have quashed the bubble…. Shiller did create the housing futures market and people not really participating in huge numbers. Many professional investors don't even short.

One of the moments that you can look at and say it started the bursting was the ABX index being created. It was a crude tool but it was a way of saying 'what do people think is going to happen with these securities?' It woke people up in a way.

Paul: You've written about a lot of issues and I'm sure that I'm missing one. I wanted to ask you about one that you spoke to back in 2006: hedge funds. Back then you wrote about how hedge funds decrease volatility in market. Now hedges have been accused of driving the shorting that brought the system to a brink. Were hedge funds right in their assessments?

[31]

I try to draw a distinction between…The problem in markets and the kind of shorting that fin. Firms were complaining about is when the market prices does not have a profound and material impact on the outcome that the price is trying to measure.

Let's take sports gambling. It's very useful; the bet in the market doesn't impact the outcome on the field. The markets are very efficient and incorporate information very quickly. It's also true in Vegas.

There is independence there and a separate from event. In the cases of the housing bubble, or John Paulson— I don't know anything specifically about Paulson or than what I read. If you look at the bets Paulson was making. Those things were independent. Ultimately those loans were going to get repaid or not regardless of what he thought was going to happen. It was useful as people might have been more hesitant to lend. You would have though Merrill Lynch would have realized this in 2006 but whatever.

[34]

When the financial firms, you can see a situation where short-selling—if you short and buy CDS you can create kind of panic. There what the short seller is doing actually helps bring about the outcome. People are exacerbating volatility. It's not independent of the outcome its actually helping it. They are jumping on a train that is already moving and making it go faster. I think there is a complicated question about the role of short-selling.

I think that the uptick rule would have been good to keep. Anything that gets markets to pause and go against a tendency of market in crisis once they tip to go in one direction, I think are good things. I do think that shorting reflected that it was hard to bet against housing in other ways.

[36]

One of the things that was true of Wall Street firms was that they had not come to terms with being public companies. And how this impacted confidence. If you leverage 30X 40x times what people think about you determines if you live.

Paul: Did some firms get the public model?

The firms that got better at managing public capital, well short-term financing, not many that did better but had a better sense of the dangers of being weak. Failures thought that access to short-term funding was guaranteed.

Also back in 2006, you wrote about the bias in home price indices were buyers and investors to reliant upon statistics in making their decisions?

Or were stories about changing fundamentals more pervasive in other ways?

At the same time you wrote about how homeowners could be better off if housing prices decline. (This is widely held by the thinking of housing services as 'rents'). Was this analysis wrong?

How did financial stress shift into the overall economy?

As you spoke to market participants, when did they begin to express concerns? Were people overly optimistic?

[39]

One thing about the press more generally, if you go back at business press, interesting how many big stories about people talking about this situation early--Sawn Tulley (??) in 2004, John Cassidy—bearish by inclination, *The Economist*.

In NYC, there were people who felt like "this is crazy" People at first thought a slight house of card dimension, say in late 2006. Were early 2007, when New Century goes under---that's late. In most of 2006, people thought the party was continuing in a way.

[41:30]

Looking back at things that I done I was, at time of New Century, I was optimistic in 2007. That was early 2007 and Bear doesn't go under for another year.

I think I was behind the curve

Firms did not get under for another year.

Paul: Bear funds and the lag until Bear, was there overconfidence?

The way that people thought, and I definitely was one of them was. I think people kept thinking that it's like a submarine. If you just seal off a compartment, then you can stop the leaking. That was really the idea. The failure of the hedge funds, when I think about when things go wrong, that's obviously a moment.

I got married on July 21, 2007. I went a honeymoon and that week it really started to get going. They both went under in June and that week or the following week Cramer on CNBC about Bernanke.

You could seal off a compartment and it would be ok. If it bursts in that compartment, then you move onto the next one.

People did not take any systemic solution. If you think about policy makers, one of the great mysteries is why between March 2008 and Aug 2008 did Hank Paulson and Ben Bernanke, why did they not go to Congress? Even if you accept that they lacked legal authority on Lehman. They never went to Congress to get it. Part of it was idea that 'if problem is big enough, we will find a way to deal with it."

Norman: On Fed interest rates? Dropped quickly and dramatically. Can you talk about monetary policy, how might have gone a different way. Argue on foreign investors

[47]

One of my problems intellectually about Greenspan, it's not obvious about the alternative. I mean I know what it was to keep rates high or go higher sooner.

First off, I'm not a hard money guy. I think that what Bernanke is doing now is right and probably not aggressive enough in terms of QE. The fed should prioritize unemployment—it obsesses about inflation because that's what bankers do.

There was a tremendous amount of money coming in to the country. The Fed doesn't control long-term rates and they were not hugely high. If you look at inflation, I don't know anyone who thinks back on the decade and thinks 'Wow, prices in the real world were soaring at all.' It's difficult to say that inflation is under control but need to raise rates because of an asset bubble.

I don't believe there are all these bubbles around the world because of Bernanke's policy. I don't think that is right. Another role that Fed could have played, I think there is a … role that fed could have paid. From Irrational Exuberance speech, the short-term effects are strong and long-run effects are nil. Had Greenspan been more publically skeptical, who knows maybe he didn't feel it, would have helped temper things a bit. Had it been more rigorous on say bank supervision?

[52]

What would have replaced housing bubble? It's possible that we would have had a long recession. I mean Volcker did it in 1982.

Norman: Can you put it off forever? If lowering of interest rates encouraged refinances/churning?

Greenspan himself talked about consumer spending driven by housing. I'm not a believer in the hang-over period of recessions.

Recessions are the result of absence of demand that monetary policy can play a role in alleviating. The question I ask is what takes the place.

McWilliams: Have you come to things that haven't come out in the press?

Not recently. Most of it has been stuff that I've written about.

McWilliams: Any unexamined areas?

[56:35]

One of the things that I am interested in, still a little opaque, one real question that I have is what relationships were like between investment banks and investors. Something seems odd about the idea of unexpecting investors. Should be reasonably sophisticated. There is a narrative that they were rubes who were taken-in

Unease?

I don't think it was a rube situation. I think it was a bubble mentality that took hold of people quite a bit. One of my hobby horses has been the role of the rating agencies. I think the role of the ratings agencies has been fundamental. Status by government conferred a tremendous amount of legitimacy. Principal-agent problems are fundamental in decisions made on Wall Street. If you are a pension investor the role is to get yield but also to cover your ass. As long as they could get triple-A

On the originators side it seems like there was quite a bit of fraud. Many fewer deals should have been done and more people should have been employed to do this work.

The reason that there are parallels to the late 1960 is that there was indifference on the backend with a focus on the front end. The result was fraud and trades that were invalidated. Both now in terms of the foreclosure process.

[1:02]

When you look at just one of those trusts, look at the paperwork, in terms of signing over each mortgage and the like. But I mean look at how much volume Wal-Mart does each day and they don't seem to have problems. The desire to do it right seems non-important.

That's the one question that we don't have an answer to—is it true that in many cases the mortgages were never signed over.

FCIC ended the conversation by asking if Surowiecki could be contacted again in the future with follow-up questions.