Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

Barnett Sivon & Natter P.C.
ATTORNEYS at LAW
WASHINGTON, DC

# The Python and the Data*

Robert Barnett

December, 2010

In the summer of 2007, many analysts used the metaphor of the Pig in the Python to describe the subprime mortgage crisis, pointing out that resets of subprime hybrid ARMs were scheduled to occur in an uneven fashion over the following 18 months or so. The bulk of those, however, were to occur during the period of January 2008 through June 2008, with resets falling to a very low rate by the concluding months of that year. Using an 18 month slice of time as the Python, therefore, the bulk of the mortgages that constituted the Pig were predicted to have gone through the pains associated with resets at an increasingly distant time in the past and by the end of that period would have been absorbed. For many of us, looking at this image, it gave comfort that if we could just maneuver through this 18 month period successfully, things would return to a more normal way of mortgage financing, and the mistakes baked into hybrid ARMs wouldn't be repeated. Housing starts might fall in 2008 to around 1,000,000 new homes, but they would recover fairly quickly once the Pig was absorbed.

It was a glaring example of the lack of the collection of relevant data by the mortgage finance industry.

Chairman Bernanke, notwithstanding all of the data collection resources of the Board of Governors, also believed recovery to be relatively short-term, saying that he didn't expect the subprime mortgage problems to infect the entire economy. To hedge their bets, however, the Fed commenced rulemaking that ultimately would ban certain creditors from offering hybrid ARMs, option ARMs or interest-only mortgages without complying with strict underwriting and disclosure standards. While it took over a year from publication of the first proposal to final adoption, and while unregulated lenders (some of whom were the worst culprits in subprime lending) were not covered, still with the cooperation of state government, that might have taken care of the problem, all other things remaining equal.

*The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

But as is often the case, all other things don't remain equal. In fact, the Pig in the Python metaphor masked the larger problems associated with both the housing industry and the economy generally. It was a neat and tidy way to describe the trunk of the elephant, if you will, but it overlooked the rest of the animal. Nothing in the analogy addressed the CDOs, for example, nor did it take into account that our economy was preparing to pop a massive housing bubble not too long after it popped a massive stock market bubble. Good data about all of this was invisible, if it existed in the aggregate at all.

And so the economy went into the tank. It did so notwithstanding that lenders could no longer originate loans without meeting minimal standards such as verification of income, for example, that had become irrelevant since the liquidity of the secondary market had dried up, the GSEs were in conservatorship, no one trusted the credit rating agencies, and loans just weren't being made. We now are in a continuing battle to assist those who are facing foreclosure. Housing starts fell below one million in both 2008 and 2009. The industry has modified more than 1.5 million mortgages for homeowners facing possible foreclosure just in 2010 alone. At the same time, the number of homeowners that were 30 days or more delinquent on payment of their mortgages totaled around 3.4 million. Through HOPE NOW, the alliance formed after the bubble burst, some financial data for the housing finance industry is being collected or otherwise we would not have those numbers.

Housing cycles do not occur on a regular predictable basis, but generally occur about 20 — 30 years apart, the length of time that it takes senior managers to cycle through housing finance firms and new managers who lack first hand experience of down markets to succeed the older experienced managers. That is also about the length of time for Congress to turn over most of its membership, and financial services regulators to come and go. While it is unlikely that Congress can legislate against the business cycles recurring, the chances are good that the intense attention in Dodd-Frank to underwriting, risk retention, disclosures, UDAP, servicing, brokers, and appraisal issues should alleviate the magnitude of the swings. Institutional history fades, but statutes and data persist.

The deception of the simple Pig in the Python metaphor, however, is a caution for everyone. There will be better times, and in those better times it is difficult to restrain activity or fail to satisfy voting consumers that find themselves constricted by rules established during a recession. It is also hard to properly dimension the issue, in part because some key facts are usually unavailable and even if available, won't be seen objectively. The competitive pressure on lenders will be exacerbated by the new rules, and that will include political pressure to serve large groups of consumers that will have been unable to qualify for those mortgages that will be offered under the new rules. If rental housing does not develop quickly enough to satisfy the increased rental housing demand that the Dodd-Frank rules will create, Congress will not remain silent, but will pass laws that force lenders to make credit more easily available.

The industry still fails to have made a commitment to a strong data collection effort that will permit it to see as an industry what is happening in the field. It has access to some data, and it is clear that the government will collect potentially immense amounts of data, but the industry remains cautious in supporting private collection of a robust data file. Part of the reason is that it cost money to collect it, and part of it is that the government collection satisfies most of the pressure for data, and any additional collection can be proprietary to individual firms and useful in competitive practices. But at the same time, the government will utilize the data it collects from the industry for its own purposes, purposes that might differ from those of the industry. In addition, government has a habit of seeking data from the industry in crisis situations such as Katrina or the current bubble. When that happens, the industry must scramble and cannot quickly assemble the necessary data — policy decisions, therefore are made without sufficient facts.

Of course, it is not clear that any data collection that the industry undertook in this millennium would have been sufficient to provide a vision of what was happening as the Pig was being fattened up in 2003 to 2007. Perhaps those engaged in CMO and CDO expansion would have resisted transparency in that area. But simple numbers such as the number of subprime hybrids, option ARMs and I/Os and their reset dates could have been collected and considered by the industry, and it might have made a difference. Certainly it could make a difference in the future.

There are solutions, some modest, some more robust. HOPE NOW could continue and expand the data it collects, for example. More aggressively, the financial services industry could develop a National Institute for Finance, comparable to the National Institutes of Health (although privately funded), and as part of that organization could include a data collection institute.

Other institutes to address various sectors of the financial services industry could also be developed and fit within the umbrella organization. Such institutes could perform the basic research that is not currently performed, and could provide resources for the finance industry in ways that the future might dictate. The clear first need would be for data. While an aggressive response to the problem, it ultimately could prove essential in a variety of ways. At a minimum, when someone used a Pig in the Python metaphor, the scope of its coverage and hence its relevance could be tested.

*Robert Barnett is a partner with the law firm of Barnett Sivon & Natter, P.C.*